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Recovery of Basis in Non-Qualifying Stock Redemptions Under Sections 302 and 304

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RECOVERY OF BASIS IN NON-QUALIFYING STOCK REDEMPTIONS UNDER SECTIONS 302 AND 304

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A controversy which frequently arises from the redemption of stock[1] by a corporation is whether the distribution by the corporation will be treated as received in exchange for the stock, thereby creating potential capital gains treatment for the redeeming shareholder, or whether the corporate distribution will be treated as a dividend and taxed as ordinary income. An issue less frequently litigated or commented upon is the proper treatment of the shareholder's basis when the distribution is treated as a dividend. This latter issue is the subject of this article.

Section 302 of the Internal Revenue Code was designed specifically to deal with redemptions by a corporation of its own stock.[2] Section 302(a) provides that if a corporation redeems its

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[1] I.R.C. § 317(b) provides: "For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

Unless otherwise specified, all statutory references are to the Internal Revenue Code of 1954 through the date of amendment by the Deficit Reduction Act of 1984, Division A (Tax Reform Act of 1984), Pub. L. No. 98-369, §§ 1-1082, 98 Stat. 494-1057 [hereinafter cited as the TRA of 1984].

[2] I.R.C. § 302. Section 302 provides, in pertinent part:

> (a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
>
> (b) Redemptions Treated as Exchanges.—
>
> (1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
>
> (2) Substantially disproportionate redemption of stock.—
>
> (A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.
>
> (B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.
>
> (C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—
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> (i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting

own stock and certain provisions of section 302(b) apply, then the "redemption shall be treated as a distribution in part or full payment in exchange for the stock."[3] If, however, the redemption does not comply with any of these provisions, then section 302(d) provides that the redemption shall be treated as a distribution of property to which section 301 applies—that is, as a distribution potentially taxable as a dividend at ordinary income rates.[4] Section 301(c)(1) provides the basic rule that in a case to which section 301(a)[5] applies, a distribution of property is included in a shareholder's gross income to the extent that it is a dividend as defined in section 316.[6] I.R.C. section 316 defines the

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stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Redemption from noncorporate shareholder in partial liquidation.—Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

[3] I.R.C. § 302(b). *See infra* notes 26-59 and accompanying text. For detailed discussions of § 302, see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶¶ 9.01-26, 9.60-65 (4th ed. 1979) [hereinafter cited as Bittker & Eustice]; Bacon, *Corporate Stock Redemptions—Definitions; Basic Categories*, Tax Mgmt. (BNA) 343-2d (1980); Kahn, *Stock Redemptions: The Standards for Qualifying as a Purchase Under Section 302(b)*, 50 Fordham L. Rev. 1 (1981) [hereinafter cited as Kahn].

[4] I.R.C. § 317(a) defines property to mean "money, securities, and any other property; except . . . stock in the corporation making the distribution (or rights to acquire such stock)."

[5] I.R.C. § 301(a) provides: "In General—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)."

[6] *See* I.R.C. § 316(a)(1). If a redemption of a shareholder's stock is deemed to be a distribution of property subject to section 301, this distribution will constitute a dividend to the

term dividend as meaning "any distribution of property . . . by a corporation to its shareholders" out of either accumulated earnings and profits or current earnings and profits. If the corporation has sufficient earnings and profits, then the entire distribution, if it is subject to section 301, will be treated as a dividend to the recipient shareholder.[7] In contrast, if the redemption is treated as an exchange under section 302, then the shareholder will receive income only to the extent that the amount realized on the exchange exceeds the shareholder's basis in the stock redeemed.[8]

Since section 302 is specifically limited to a redemption by a corporation of its own stock, section 304 was enacted as protection against the sale of stock in one corporation to a related corporation as a means of circumventing the redemption rules of section 302.[9] Without section 304, a person who controlled two corporations could, instead of causing one of the corporations to redeem its own stock, sell the stock in that corporation to the second corporation under his control. Shareholders, if permitted to retain such powers, could bail out corporate earnings at capital gain rates without relinquishing their control over the corporations.[10] To guard against this maneuver, section 304 treats sales of stock in one corporation to certain related corporations as redemptions subject to the rules of section 302.[11] In order to obtain exchange

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extent of the corporation's earnings and profits.

For an explanation of the term "earnings and profits," see Edelstein, *Earnings and Profits—General Principles & Treatment of Specific Items*, Tax Mgmt. (BNA) 715-3rd (1982).

[7] If the distribution exceeds the corporation's earnings and profits, such excess is applied against and reduces the shareholder's basis in his stock. *See* I.R.C. § 301(c)(2). If the distribution exceeds the shareholder's adjusted basis in his stock, the excess is generally "treated as gain from the sale or exchange of property." I.R.C. § 301(c)(3)(A). It is still unresolved whether a shareholder, in a dividend equivalent redemption, would reduce his basis in all of his stock, or only in the stock actually redeemed before reporting capital gains. For authority in support of the latter approach, see Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971), *rev'g* 303 F. Supp. 1 (E.D. Va. 1969); Note, *Aggregation of Bases under Sections 301(c)(2) and (3)*, 33 Tax Law. 937 (1980). *But see* Bittker & Eustice, *supra* note 3, at ¶ 9.01 n.1; 2 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation: Cases and Materials 453 (2d ed. 1980).

[8] *See* I.R.C. § 1001. Usually, a redemption qualifying under § 302 will receive capital gains treatment. *See, e.g.*, I.R.C. §§ 1202, 1221, 1222.

[9] Section 304(a)(1) applies to sales of stock between brother and sister corporations. *See infra* notes 63-65 and accompanying text. Section 304(a)(2) applies to sales of a parent corporation's stock to a subsidiary corporation. *See infra* notes 66-69 and accompanying text.

[10] *See generally* Bittker & Eustice, *supra* note 3, at ¶¶ 9.30-.32.

[11] *See* I.R.C. §§ 304(a)(1), (a)(2).

treatment, the sale, recharacterized as a constructive redemption, must fulfill the requirements of section 302(b). Failure to qualify under section 302 may cause the entire distribution to be treated as a dividend under the rules of section 301.

Virtually all of the litigation concerning either section 302 or section 304 focuses on the question of whether to classify the distribution to the shareholder as being received in exchange for stock or as a dividend.[12] A concomitant and rarely discussed issue, however, is the treatment of the shareholder's basis in the redeemed stock if the redemption is treated as a dividend rather than as an exchange. Where the redemption is treated as an exchange, the shareholder can offset his basis in the redeemed stock against the proceeds of the redemption in computing gain or loss.[13] Whenever a redemption is taxed as a dividend, however, the question arises as to the proper method for recovery of the basis in the redeemed stock. This basis problem can appear in either a section 302 or section 304 situation. A shareholder who receives dividend treatment when a portion of his stock is redeemed must be given the opportunity to recoup his basis in this redeemed stock. The necessity for a clearly defined basis recovery system becomes even more apparent where the shareholder's stock is completely redeemed in a dividend equivalent redemption.[14] In such a redemption, the shareholder has transferred all of his stock back to the corporation, but has received dividend treatment for the entire amount of the distribution.[15] An analogous situation also arises in a section 304 situation, when the shareholder, after the constructive redemption, no longer actually owns stock in either of the corporations which participated in the transaction.[16] Without an established basis recovery procedure, a shareholder who received dividend treatment in a complete redemption could lose the tax benefit of his basis in the

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[12] *See generally infra* notes 76-162 and accompanying text.

[13] *See* I.R.C. § 1001.

[14] Throughout this article, the term "dividend equivalent redemption" is intended to mean a redemption which has failed to meet the requirement of paragraphs (1), (2), (3) or (4) of § 302(b) and will thus be treated as a distribution subject to § 301. At times, the term "non-qualifying redemption" will also be used to mean such a redemption.

[15] Any statement in this article to the effect that the distribution in redemption is treated as a dividend assumes that the corporation's earnings and profits are sufficient to cover the entire amount of the distribution. *See infra* notes 83-145 and accompanying text; *see also supra* note 6 and accompanying text.

[16] *See infra* notes 153-157 and accompanying text.

redeemed stock.

A shareholder will often fail to receive exchange treatment in a complete redemption under section 302 or section 304 because he is treated as constructively owning stock in the corporation through the application of the attribution rules of section 318.[17] These intricate attribution rules assume a community of in-

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[17] *See* I.R.C. § 318. Section 318 provides:

(a) General Rule.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) Members of family.—

(A) In general.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren and parents.

(B) Effect of adoption.—For purposes of subparagraph (A)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) Attribution from partnerships, estates, trusts, and corporations.—

(A) From partnerships and estates.—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

(B) From trusts.—

(i) Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in porportion to the actuarial interest of such beneficiaries in such trust.

(ii) Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(C) From corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) Attribution to partnerships, estates, trusts, and corporations.—

(A) To partnerships and estates.—Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(B) To trusts.—

(i) Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest,

terest among a group of persons and require that stock owned by one person or entity be treated as owned by other members of the attribution group.[18] The constructive ownership rules, as will be seen, exacerbate the problem of the proper treatment of a redeemed shareholder's stock basis.[19]

This perplexing basis question, at times referred to as "the mystery of the disappearing basis"[20] and "the case of the forgotten basis,"[21] remains unsettled. The Code provides no guidance for re-

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computed actuarially, is 5 percent or less of the value of the trust property.

(ii) Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.

(C) To corpoartions.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

(4) Options.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(5) Operating rules.—

(A) In general.—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4), shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.

(B) Members of family.—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) Partnerships, estates, trusts, and corporations.—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

(D) Option rule in lieu of family rule.—For purposes of this paragraph, if stock may be considered as owned by an individual under paragraph (1) and (4), it shall be considered as owned by him under paragraph (4).

Section 318 is specifically applicable to § 302 and § 304 redemptions. *See* I.R.C. §§ 302(c); 304(b)(1), (c)(3).

[18] General discussions of the application of § 318 to redemptions include Bittker & Eustice, *supra* note 3, at ¶ 9.21; 2 Z. Cavitch, Tax Planning For Corporations and Shareholders § 7.03[3] (1980); Cavitch, *Problems Arising from the Attribution Rules*, 35 Inst. on Fed. Tax'n 801 (1977); Schoenfeld, *Constructive Ownership Rules Under Section 318*, Tax Mgmt. (BNA) 72-4th (1980).

[19] *See infra* notes 88-145 and accompanying text.

[20] *See* Bittker & Eustice, *supra* note 3, at ¶ 9.62.

[21] *See* Katcher, *The Case of the Forgotten Basis: An Admonition to Victims of Internal*

covery of basis in either a non-qualifying section 302 redemption or a dividend equivalent constructive redemption under section 304. The Treasury regulations under sections 302 and 304 attempt to establish some guidelines for basis recovery in dividend equivalent redemptions,[22] but fail to resolve a number of important questions. Very little judicial authority exists on the question of the proper treatment of the shareholder's basis in these situations. Finally, the revenue rulings do not shed much light on this subject and, at times, reach startling conclusions concerning the proper treatment of a shareholder's basis.[23]

In 1976, the Section of Taxation of the American Bar Association proposed legislation which would have provided some certainty in the area.[24] Under the proposed legislation, if a shareholder continued to own stock in the corporation following a non-qualifying section 302 or dividend equivalent section 304 redemption, the basis in the stock redeemed would simply be transferred to the remaining shares owned. If the shareholder did not own any other stock in the corporation following the redemption, then the shareholder would be permitted to deduct the basis in the stock redeemed as a loss from the exchange of the stock.[25]

This article will review the redemption provisions of both section 302 and section 304, discuss the existing rules for basis recovery in dividend equivalent redemptions, and highlight the situations where the recovery of the basis of the stock redeemed becomes a problem. A number of cases, revenue rulings, and hypothetical illustrations where the basis recovery of redeemed stock has created or potentially could create a problem will be examined. The article will also analyze the tax policies which may influence the structure of a basis recovery procedure in dividend equivalent redemptions,

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Revenue Code Section 115(g), 48 Mich. L. Rev. 465 (1950) [hereinafter cited as Katcher]. For a related discussion focusing on § 306, see generally Brodsky & Pincus, *The Case of the Reappearing Basis*, 34 Taxes 675 (1956).

[22] *See* Treas. Reg. § 1.302-2(c); Treas. Reg. § 1.304-2(a); Treas. Reg. § 1.304-3(a); *see also infra* notes 72-75 and accompanying text.

[23] *See infra* notes 106-107 and accompanying text.

[24] *See* ABA Tax Section (Draft) Recommendation No. 1976-6, 29 Tax Law. 1156 (1976) (adopted as amended), *reprinted in* 30 Tax Law. 498 (1977); *see also* 102 Ann. Rep. ABA 464, 467. The Section's recommendation was approved by the ABA House of Delegates on Feb. 14, 1977. *See id.* at 219.

[25] *See infra* notes 182-192 and accompanying text. In most cases, this treatment would create a capital loss for the redeemed shareholder.

and will suggest the recovery method which should be adopted. Finally the legislative changes proposed by the American Bar Association's Section of Taxation will be reviewed and discussed.

I. Background of Section 302

The present section 302 was introduced into law in the 1954 Code. In subsection 302(b), entitled "Redemptions Treated as Exchanges," Congress incorporated the existing law under section 115(g)(1) of the 1939 Code, which provided that a redemption shall be treated as an exchange if it is not essentially equivalent to a dividend.[26] Additionally, Congress introduced the "substantially disproportionate" test under section 302(b)(2)[27] and the "complete termination of shareholder's interest" test under section 302(b)(3).[28] These new standards were enacted by Congress in order to provide greater certainty of results in specific instances.[29] To protect against the ability of shareholders to divide their stock ownership in corporations among certain related parties in an effort to obtain favorable tax treatment and maintain control over the corporate entity, Congress also created the constructive ownership rules of section 318,[30] which were made specifically applicable to redemptions.[31]

A. *Substantially Disproportionate Redemptions*

Section 302(b)(2) established a mechanical formula for determining whether a distribution in redemption of stock qualifies for exchange treatment under section 302(a). In order for a redemption to qualify under this subsection, it must meet the following three tests: (1) immediately after the redemption the redeemed

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[26] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 233-34, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4870.

[27] *See* I.R.C. § 302(b)(2).

[28] *See* I.R.C. § 302(b)(3).

[29] *See supra* note 26; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 222(c), (d), 96 Stat. 32, 478-80 (amending § 302(b) to add a new paragraph to deal with redemption from noncorporate shareholders in partial liquidations, and amending § 346 (defining partial liquidations)) [hereinafter cited as TEFRA]. This article does not focus on such partial liquidations.

[30] *See supra* note 2; *see generally* S. Rep. No. 1622, *supra* note 26, 235-37, 239-40, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4872-74, 4876-77.

[31] *See* I.R.C. § 302(c)(1).

shareholder must own (directly or constructively through attribution) less than 50% of the combined voting power of all classes of stock entitled to vote;[32] (2) the shareholder's percentage of the total outstanding voting stock which he owns, directly or constructively, immediately after the redemption must be less than 80% of his direct and constructive ownership of such stock immediately before the redemption;[33] and (3) the shareholder's percentage of outstanding common stock (whether voting or nonvoting) which he owns, either directly or constructively, after the redemption must be less than 80% of his direct ownership or constructive ownership of such stock immediately before the redemption. Furthermore, if there is more than one class of common stock, this 80% threshold shall be determined by reference to the fair market value of the common stock.[34]

A distribution in redemption of a portion of the stock actually owned by the shareholder will normally be treated as a dividend under section 301 if the redemption fails to qualify under the mechanical formula of section 302(b)(2), or if it is "essentially equivalent to a dividend" within the meaning of section 302(b)(1).[35] Assuming that the entire distribution is treated as a dividend, the Code makes no provision for the immediate recovery of basis for the redeemed stock. The question then arises whether the redeemed shareholder should be required to transfer his basis in the redeemed stock to his remaining stock in the corporation, or whether he should be entitled to recover it immediately as a loss deduction.[36]

B. *Termination of a Shareholder's Interest*

Section 302(b)(3) provides that a distribution shall be treated as

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[32] *See* I.R.C. § 302(b)(2)(B).

[33] *See* I.R.C. § 302(b)(2)(C).

[34] *See* I.R.C. § 302(b)(2). Treas. Reg. § 1.302-3(a) provides that "section 302(b)(2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock." Treas. Reg. § 1.302-3(a). Although § 302(b)(2) refers only to common stock, the Treasury has ruled that "redemption of voting preferred stock can qualify as a substantially disproportionate redemption under section 302(b)(2) even though the redeeming shareholder does not experience a reduction in common stock ownership, if the shareholder owns no common stock either directly or constructively." Rev. Rul. 81-41, 1981-1 C.B. 121. *See* Kahn, *supra* note 3, at 7 n.37.

[35] *See infra* notes 49-56 and accompanying text.

[36] *See infra* notes 76-82 and accompanying text.

an exchange if it is in complete redemption of all the shareholder's stock in the corporation.[37] Although section 302(c) makes the attribution rules of section 318 applicable in determining the ownership of stock for purposes of a redemption, section 302(c)(2) provides a specific exception from such application for complete terminations. Section 302(c)(2) states that the family attribution rules of section 318(a)(1) do not apply to a complete redemption of a shareholder's interest in the corporation if: (1) "immediately after the distribution, the [shareholder] has no interest in the corporation (including an interest as [an] officer, director, or employee), other than an interest as a creditor,"[38] (2) "the [shareholder] does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution,"[39] and (3) the shareholder files an agreement to notify the Secretary of the Treasury of any acquisition of the corporation's stock within ten years of the date of the distribution in question.[40] Consequently, when a shareholder who files an agreement under section 302(c)(2) acquires a prohibited interest in the corporation within the ten year period specified in the statute, section 302(c)(2) will cease to apply and the attribution rules under section 318(a)(1) will be deemed to have applied to the redemption.[41] Thus recharacterized, the redemption will undoubtedly be treated as a distribution to which section 301 should have applied, and the Internal Revenue Service will issue a tax deficiency for the year in which the redemption occurred. The entire amount of the distribution will be treated as a dividend to the extent of the corporation's earnings and profits existing in the year of the redemption.[42]

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[37] I.R.C. § 302(b)(3). This section incorporates a prior administrative interpretation in Treas. Reg. 111, § 29.115-9 (1943) which provided that: "[a] cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." *See also* Treas. Reg. 118, § 39.115(g)-1(a)(2) (same provision).

[38] I.R.C. § 302(c)(2)(A)(i).

[39] I.R.C. § 302(c)(2)(A)(ii).

[40] *See* I.R.C. § 302(c)(2)(A)(iii). If the shareholder does acquire the prohibited interest in the corporation within ten years from the date of the distribution, then the statute of limitations for making an assessment and the collection by levy for a court proceeding shall include a period of "one year immediately following the date on which the [shareholder] . . . notifies the Secretary [of the acquisition of the prohibited interest]." *See id.*

[41] *See* I.R.C. § 302(c)(2)(A).

[42] *See* Rev. Rul. 75-2, 1975-1 C.B. 99.

Two possible basis problems could arise under section 302(b)(3). First, a reclassification at a later date of a redemption as a dividend potentially raises serious problems regarding the treatment of the shareholder's basis in the stock which had been previously redeemed. Such problems could arise where the former shareholder, although he does not acquire shares in the corporation, becomes an officer, director or employee. When exchange treatment is revoked under section 302(b)(3), the entire distribution may become subject to taxation and the former shareholder may be unable to directly recover his basis in the stock redeemed.[43]

Second, the basis problem could arise if an entity shareholder, such as a trust, an estate, a corporation or partnership,[44] though completely redeemed, is prevented from waiving constructive ownership of stock under section 302(c)(2). As a general proposition, only the family attribution rules may be waived under section 302(c)(2).[45] Therefore, an entity whose constructive stock ownership arises from an entity-beneficiary relationship would be precluded from waiving such attribution and would not qualify under section 302(b)(3).[46] If the entity could not meet the requirements of sections 302(b)(1) or 302(b)(2), then, assuming the entire distribution is treated as a dividend, the shareholder would be faced with a basis recovery problem on its totally redeemed stock.[47]

C. *Redemptions Not Equivalent to a Dividend*

Section 302(b)(1) provides that a distribution in redemption shall be treated as an exchange if the redemption is "not essen-

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[43] *See infra* notes 88-132 and accompanying text.

[44] *See* I.R.C. § 318(a)(3)(A),(B) & (C).

[45] Section 302(c)(2)(A) provides that in the case of a complete redemption under § 302(b)(3), § 318(a)(1) (family attribution rules) will not apply if the additional requirements of § 302(c)(2) are met. *See supra* note 17.

[46] *But see* Rickey v. United States, 592 F.2d 1251 (5th Cir. 1979), *reh'g denied*, 599 F.2d 1054 (1979). For a discussion and criticism of *Rickey*, see *infra* notes 116-126 and accompanying text.

[47] Another question is whether an entity can utilize § 302(c)(2) to waive family attribution which had occurred as an earlier link in a chain attribution situation. The Service and the courts have long debated the propriety of such waivers, but Congress has recently enacted legislation to permit entities to waive family attribution. *See infra* notes 111-113 and accompanying text; TEFRA, § 228, *adding* I.R.C. § 302(c)(2)(C). Ultimately, the failure of an entity to properly waive the family attribution rules will cause dividend treatment to the entity and create the problem of the proper recovery by the entity of its basis in the redeemed stock.

tially equivalent to a dividend."[48] This section was designed to be a reenactment of the law existing under the pre-1954 Code.[49] During the years immediately following the enactment of section 302(b)(1), little additional light was shed on the proper interpretation of the phrase "not essentially equivalent to a dividend." Finally, in 1970, the Supreme Court in *United States v. Davis*[50] enunciated specific rules for the interpretation of section 302(b)(1). First, the Court concluded that the attribution rules of section 318(a) apply for purposes of deciding whether a distribution is not essentially equivalent to a dividend under section 302(b)(1).[51] Second, the Court stated that a sole (whether directly or through attribution) shareholder's redemption of stock is always "essentially equivalent to a dividend."[52] Third, the Court ruled that the business purpose of a transaction is irrelevant in determining dividend equivalence under 302(b)(1).[53] Finally, the Court said that in order to qualify for exchange treatment under section 302(b)(1), a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.[54]

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[48] I.R.C. § 302(b)(1).

[49] *See* S. Rep. No. 1622, *supra* note 26, at 234, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4870. The Senate Finance Committee's report stated that the test intended to be incorporated in interpreting § 302(b)(1) was the one employed under § 115(g) of the 1939 Code. The report also indicated that in applying this test in the future the inquiry would be devoted solely to the question of whether or not the transaction by its nature could properly be characterized as a sale of stock by the redeeming shareholder to the corporation. *See id.* at 234, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4870-71.

[50] 397 U.S. 301 (1970).

[51] *See id.* at 307.

[52] *See id.* at 307 (quoting I.R.C. § 302(b)(1)).

[53] *See id.* at 312 (citing Hasbrook v. United States, 343 F.2d 811, 814 (2d Cir. 1965)).

[54] *See Davis*, 397 U.S. at 313. The Service's interpretation of "meaningful reduction" has been developed in the following revenue rulings: Rev. Rul. 75-502, 1975-2 C.B. 111 (meaningful reduction resulted where estate went from owning 57% of the voting stock directly to 50% through attribution); Rev. Rul. 75-512, 1975-2 C.B. 112 (meaningful reduction resulted where trust owned directly and constructively 30% of the voting stock before redemption and 24.3%, constructively, after the redemption); Rev. Rul. 76-364, 1976-2 C.B. 91 (meaningful reduction resulted where shareholder's percentage of voting stock was reduced from 27% to 22.27%); Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction of percentage ownership in publicly held corporation from .001118% to .0001081% was not meaningful, and qualified under section 302(b)(1)); Rev. Rul. 77-426, 1977-2 C.B. 87 (redemption of any amount of nonvoting, nonconvertible preferred stock is a meaningful reduction if shareholder does not own, directly or constructively, stock of any other class); Rev. Rul. 78-401, 1978-2 C.B. 127 (reduction of shareholder's stock interest from 90% to 60% not a meaningful reduction). *But see* Wright v. United States, 482 F.2d 600 (8th Cir. 1973) (reduction of a shareholder's voting power from 85% to 61.7% was a meaningful reduction).

Although the *Davis* decision established broad guidelines for the proper interpretation of section 302(b)(1), a number of issues have continued to arise concerning the section's scope and interpretation. Recent decisions have considered the extent to which the attribution rules should be employed in a section 302(b)(1) situation. The First Circuit has ruled that hostility within a family group may be a mitigating factor which discounts the importance of the constructive stock ownership rules in the application of section 302(b)(1).[55] The court stated that the principle of family discord could belie the community of interest rationale of the attribution rules, and, therefore, in such situations, the constructive ownership rules should only be one of the facts considered in determining the applicability of section 302(b)(1).[56]

The Tax Court has recently rejected the position of the First Circuit with respect to the role of family hostility or discord in this area.[57] It stated that the court should not consider family hostility if, after the redemption, there has been no reduction in the shareholder's proportionate direct or constructive interest in the corporation.[58]

As in the case of sections 302(b)(2) and 302(b)(3), a potential basis problem arises under section 302(b)(1). The family hostility rule, although seemingly tangential to the question of the treatment of the redeemed shareholder's basis, is actually of potential significance. If a shareholder is completely redeemed, and if the shareholder cannot meet the requirements of section 302(b)(3) because he does not qualify for a waiver under section 302(c)(2),[59] then section 302(b)(1) would become the primary sec-

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More detailed analysis of "meaningful reduction" can be found in Blumstein, *When Is a Redemption "Not Essentially Equivalent to a Dividend?"*, 7 J. Corp. Tax'n 99 (1980); Holden & Serling, *Section 302 Redemptions: New Principles and Prospects*, 11 Cum. L. Rev. 553 (1980) [hereinafter cited as Holden & Serling]; Kahn, *supra* note 3, at 15-29; Postelwaite & Finneran, *Section 302(b)(1): The Expanding Minnow*, 64 Va. L. Rev. 561 (1978); Note, *I.R.C. § 302(b)(1): Dividend Equivalency After United States v. Davis*, 7 Fla. St. U.L. Rev. 505 (1979).

[55] *See* Robin Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975). For a detailed discussion of *Haft*, see *infra* note 145.

[56] *See Haft*, 510 F.2d at 48.

[57] *See* David Metzger Trust v. Commissioner, 76 T.C. 42, 60-61 (1981), *aff'd*, 693 F.2d 459 (5th Cir. 1983), *cert. denied*, 103 S. Ct. 3537 (1983). For a discussion of this case, see *infra* note 145.

[58] *See Metzger*, 76 T.C. at 60-61.

[59] A shareholder may not qualify for redemption treatment under § 302(b)(3) if he fails to

tion under which the redeemed shareholder would seek exchange treatment.

If the family hostility rule is rejected as a mitigating factor, then the operation of the attribution rules may cause a completely redeemed shareholder to fail to qualify under section 302(b)(1) and to receive dividend treatment on the entire distribution. The ultimate question to be resolved is whether the shareholder's basis in the redeemed stock is recovered, is lost, or is transferred in some manner to the persons—including hostile persons—whose stock was attributed to the redeemed shareholder.

II. Background of Section 304

Section 304 was designed to treat sales to certain related corporations as redemptions, and to provide rules to determine whether such a redemption should be taxed as a distribution pursuant to section 301 or as an exchange under section 302.[60] The precursor of section 304 was section 115(g)(1) of the 1939 Code, enacted by Congress in 1950.[61] This section only applied to a parent corporation's redemptive sale of stock to its subsidiary. Section 304 of the 1954 Code carried forward the parent-subsidiary provision of the 1939 Code and added a new provision to control stock sales between brother-sister corporations.[62]

A. *Brother-Sister Constructive Redemptions*

Under section 304(a)(1), if one or more persons are in control of each of two corporations and one corporation acquires the stock of the other from such controlling person or persons in return for property, the transaction is treated as a redemption of the acquiring corporation's stock.[63] The rules of section 302 determine

meet the requirements of § 302(c)(2) for waiver of the family attribution rules. The shareholder may acquire a prohibited interest within the 10 year period specified in § 302(c)(2), or may have received attribution through a method other than family attribution, e.g., beneficiary to entity attribution. *See* I.R.C. § 318(a)(3).

[60] *See* S. Rep. No. 1622, *supra* note 26, at 239, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4876-77.

[61] *See* Revenue Act of 1950, ch. 994, § 208(a), 64 Stat. 931-32.

[62] *See* S. Rep. No. 1622, *supra* note 26, at 239, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4876-77; *see also* I.R.C. § 304(a)(1).

[63] *See* I.R.C. § 304(a)(1). The term "control" is defined in § 304(c):

(1) In general.—For purposes of this section, control means the ownership of stock

whether to treat this constructive redemption as a section 301 distribution or as an exchange. In applying the standards of section 302 to the constructive redemption of the acquiring sister corporation's stock, section 304(b)(1) provides that the redemption will be measured solely by reference to the change in proportionate interests of the selling shareholder in the stock of the issuing brother corporation.[64] If the hypothetical redemption does not meet the

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possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) Stock acquired in the transaction.—For purposes of subsection (a)(1)—

(A) General rule.—Where 1 or more persons in control of the issuing corporation transfer stock of such corporation in exchange for stock of the acquiring corporation, the stock of the acquiring corporation received shall be taken into account in determining whether such person or persons are in control of the acquiring corporation.

(B) Definition of control group.—Where 2 or more persons in control of the issuing corporation transfer stock of such corporation to acquiring corporation, and, after the transfer, the transferors are in control of the acquiring corporation, the person or persons in control of each corporation shall include each of the persons who so transfer stock.

(3) Constructive ownership.—

(A) In general.—Section 318(a) (relating to constructive ownership of stock) shall apply for purposes of determining control under this section.

(B) Modification of 50-percent limitations in section 318.—For purposes of subparagraph (A)—

(i) paragraph (2)(C) of section 318(a) shall be applied by substituting "5 percent" for "50 percent", and

(ii) paragraph (3)(C) of section 318(a) shall be applied—

(I) by substituting "5 percent" for "50 percent", and

(II) in any case where such paragraph would not apply but for subclause (I), by considering a corporation as owning the stock (other than stock in such corporation) owned by or for any shareholder of such corporation in that proportion which the value of the stock which such shareholder owned in such corporation bears to the value of all stock in such corporation.

I.R.C. § 304(c) (as amended by the TRA of 1984, § 712(*l*)(5)). Prior to the TRA of 1984, the general 50% threshold under § 318(a) applied to determine whether control existed under § 304. *See, e.g.*, I.R.C. § 318(a) (1982); *see also* H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1783 (1984).

[64] *See* I.R.C. § 304(b)(1). The constructive ownership rules of § 318 are applicable in determining the selling shareholder's stock ownership in the issuing corporation. These rules are also applied in determining whether the taxpayer is in control of both corporations. *See* I.R.C. § 304(c)(3).

requirements of section 302(b) and the distribution is governed by section 301, "the determination of the amount which is [treated as] a dividend (and the source thereof) shall be made as if the property were distributed (A) by the acquiring corporation to the extent of its earnings and profits, and (B) by the issuing corporation to the extent of its earnings and profits."[65]

B. Parent-Subsidiary Constructive Redemptions

Section 304(a)(2) provides that if a subsidiary corporation acquires stock in its parent corporation from a shareholder of the parent corporation in return for property, then the transaction shall be treated as a hypothetical redemption of the issuing parent's stock.[66] Whether the hypothetical redemption of the parent corporation stock qualifies for exchange treatment under section 302(b) depends on the change, if any, in the shareholder's proportionate stock ownership in the issuing parent corporation,[67] and the constructive ownership rules of section 318 are applicable in making this determination.[68] If the constructive redemption of the issuing parent corporation stock does not qualify under section 302

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[65] I.R.C. § 304(b)(2)(A), (B) (as amended by the TRA of 1984, § 712(*l*)(1)). In general, this new rule for determining the amount of the dividend applies to transactions after October 21, 1983. *See* TRA of 1984, § 712(*l*)(7). However, the 1984 legislation does allow a taxpayer to elect to have this amendment apply "as if included in section 226 of [TEFRA]," which states that "the determination of the amount [treated as] a dividend shall be made as if the property were distributed by the issuing corporation to the acquiring corporation and immediately thereafter distributed by the acquiring corporation." *See* TRA of 1984, § 712(*l*)(7)(B); TEFRA § 226.

TEFRA strengthened § 304(a)(1) to prevent the bailout of corporate profits at capital gains rates. Such bailouts are accomplished through the borrowing of funds secured by the stock of a corporation having earnings and profits, and the subsequent contribution of this stock to a newly-formed holding company in exchange for the holding company's stock plus its assumption of the liability for the borrowed funds. *See generally* H.R. Rep. No. 760, 97th Cong., 2d Sess. 541-543, *reprinted in* 1982 U.S. Code Cong. & Ad. News at 1315-17.

[66] Control of the subsidiary corporation by the parent corporation is defined in § 304(c). *See supra* note 63.

Section 304(a)(1) indicates that the parent-subsidiary relationship takes precedence over a brother-sister relationship. Since a brother-sister relationship could be re-interpreted as a parent-subsidiary relationship through the application of the constructive ownership rules of §§ 304 and 318, at least one authority has suggested that the parent-subsidiary rules of § 304 will only apply where the potential parent corporation has at least some actual stock ownership in the subsidiary corporation. *See* Bittker & Eustice, *supra* note 3, at ¶ 9.31. This position is supported by Treas. Reg. § 1.304-2(c) (example 1).

[67] *See* I.R.C. § 304(b)(1).

[68] *See id.*

and is treated as a distribution pursuant to section 301, the distribution will be treated as a dividend to the extent of the acquiring corporation's earnings and profits. The amount of the dividend is determined under section 304(b)(2).[69]

Basis problems similar to those encountered in an actual section 302 redemption can arise in section 304 redemptions as well. When a transaction is classified as a constructive redemption under section 304, the normal rules of section 302 are employed in determining whether the distribution is in exchange for the stock or is treated as a dividend. The questions of when an entity can waive family attribution for purposes of section 302(b)(3), whether family hostility exists as an exception in a section 302(b)(1) redemption, and whether the redeeming shareholder who has waived family attribution under section 302(c)(2) has continued to meet the waiver requirements for the requisite time period, are also important in a section 304 transaction and can significantly affect the selling shareholder's basis in his transferred stock.[70]

III. Status of Existing Rules For Basis Recovery

Congress, the courts, and the Internal Revenue Service have failed to develop a comprehensive and coherent approach to deal with the potential basis problems encountered in nonqualifying redemption under both section 302 and section 304. Congress has never enacted legislation to allow for the recovery of the basis of the transferred stock when the entire distribution is treated as a dividend. As will be seen, a few courts have made sporadic attempts to provide guidance in this area. In most cases, however, the courts have only been faced with the task of classifying the

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[69] *See* I.R.C. § 304(b)(2); *supra* text accompanying note 65. This theoretical distribution to the parent of the property which the subsidiary transferred to the parent's shareholder is designed to increase the parent's earnings and profits by the amount of the subsidiary's earnings and profits attributable to this property distribution. The Tax Court has ruled this hypothetical distribution does not create a constructive dividend to the parent. *See* Webb v. Commissioner, 67 T.C. 293 (1976) (purchase of parent's stock by a subsidiary corporation from shareholder of parent corporation did not constitute a dividend to the parent when the parent was later liquidated), *aff'd per curiam*, 572 F.2d 135 (5th Cir. 1978); Virginia Materials Corp. v. Commissioner, 67 T.C. 372 (1976) (wholly owned subsidiary's purchase of its parent's stock from a shareholder of parent did not constitute dividend to parent), *aff'd without opinion* (4th Cir. 1978); *acq.* Rev. Rul. 80-189, 1980-2 C.B. 106.

[70] *See infra* notes 146-162 and accompanying text.

distribution as either received in exchange for stock, or as a dividend, and not with the issue of recovery of the redeemed shareholder's basis in his stock. The regulations, although attempting to provide some answers to the basis problem, leave unresolved a number of potential problems for both section 302 and section 304 redemptions.

A. *Regulations for Section 302 Redemptions*

Treasury Regulation section 1.302-2(c) provides: "In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed."[71] The regulations expand upon this statement through three examples. Where a partial redemption of stock is treated as a dividend distribution under section 301, the examples suggest that the basis in the redeemed stock is simply reallocated and added to the shareholder's basis in his remaining stock.[72] Unfortunately, the regulations do not establish explicit guidelines for handling the basis of the redeemed shareholder's stock where the *complete* redemption of the stock has been treated as a dividend. The illustration in example 2 of the regulation is the only applicable example, but it is imprecise, and its proper interpretation is therefore uncertain.[73] There, a husband purchased all of the stock of X Corporation for $100,000. Subsequently he gave one half of the stock to his wife. Eventually, X Corporation redeemed all of the husband's stock for $150,000. It was determined that the distribution in re-

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[71] Treas. Reg. § 1.302-2(c).

[72] *See id.* In the first example, an individual purchased all of the stock in X Corporation for $100,000. The corporation then redeemed one-half of the stock for $150,000, and this redemption was treated as a dividend. The example states that the remaining stock owned by X Corporation would have a basis of $100,000. In other words, A's basis in the stock redeemed was simply added to his basis in the remaining stock.

Example 3 is similar to example 1 in its approach. In example 3, a husband and wife each owned 500 shares of X Corporation stock. The husband had purchased all of the stock for $100,000, and had given 500 shares to his wife. Consequently, both the husband and the wife had a basis of $50,000 in their 500 shares. Ultimately, X Corporation redeemed all but 10 shares of the stock of the husband. This redemption was treated as a distribution of dividend. Example 3 states that the husband would continue to hold 10 shares of X Corporation stock with a basis of $50,000. Again, the regulations simply added the basis of the stock redeemed to the basis of the remaining stock of the husband. *See* Treas. Reg. § 1.302-2(a) (examples 1-3).

[73] *See* Treas. Reg. § 1.302-2(a) (example 2).

demption constituted a dividend. Example 2 states that immediately after the redemption, the wife would hold the remaining stock of X Corporation with a basis of $100,000, although she would have received a basis of $50,000 in the stock initially given to her by her husband. This example, without explanation, simply added the husband's basis in his redeemed stock to the stock of the wife.[74]

Regardless of the correct interpretation of Example 2, the regulations do not produce an acceptable technique for basis recovery where a totally redeemed shareholder has received dividend treatment. Simply transferring this basis to the persons from whom attribution emanates is not the proper solution. The following review of cases and revenue rulings will demonstrate that the unresolved status of a family hostility exception for section 302(b)(1) purposes, and the limitations on the ability of entities to waive attribution, further obfuscates the proper treatment of the redeemed shareholder's basis. This confusion is heightened in situations where the total redemption, once classified as meeting the requirements of section 302(b)(3), is retroactively determined to be a dividend because of the shareholder's reacquisition of a prohibited interest within the time period established by section 302(c)(2).

B. *Regulations for Section 304 Constructive Redemptions*

The correct method for recovery of a redeemed shareholder's basis for certain section 304 redemptions remains unresolved. If the distribution to the selling shareholder is treated as a dividend either in a brother-sister constructive redemption or a parent-sub-

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[74] One possible interpretation of this example is that the Commissioner intended to establish a rule which would transfer the shareholder's basis in the redeemed stock to the stock which the shareholder constructively owned and which caused the complete redemption to be treated as a dividend. A second possible interpretation is to view this example as merely a variation of examples 1 and 3. Under this analysis, the husband's actions could be treated as equivalent to having first redeemed one-half of his stock and then transferred the remaining one-half to his wife. Such an explanation would make example 2 similar to the other examples because the basis of the stock redeemed is simply transferred to the retained stock. Example 2 may be quite different from the situation where the redeemed shareholder never directly owned any of the shares of stock attributed to him. In such cases, the shareholder would never have had the opportunity to have redeemed the stock first and then give away the retained shares to another party. Consequently, example 2 may be inapposite to a number of potential basis problems.

sidiary constructive redemption, then a mechanism is needed to permit the selling shareholder to recoup the tax benefit of his basis in the stock which he transferred. The regulations do not provide for the proper treatment of a selling shareholder's basis in the issuing brother corporation when the selling shareholder does not directly own any stock in the acquiring sister corporation.[75] Furthermore, the regulations fail to provide proper guidance where the selling shareholder, after transferring his stock to the acquiring subsidiary corporation, no longer directly owns any stock in the issuing parent corporation. Finally, the regulations do not address the possible section 304 situations where, after the shareholder has transferred his stock, he owns stock in neither the issuing corporation nor in the acquiring corporation.

C. *Discussion of Cases, Revenue Rulings and Illustrative Problems*

1. *Partial Stock Redemption Under Section 302*

In *United States v. Davis*,[76] the Supreme Court held that in a partial redemption of stock where the entire distribution was treated as a dividend, the redeemed shareholder did not lose his basis in the redeemed stock, but simply added it to his basis in his remaining stock in the corporation. The taxpayer in *Davis* had formed a corporation with Bradley.[77] Initially, Davis owned 250 shares of voting common stock and 1000 shares of preferred; Davis'

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[75] In the brother-sister situation, the regulations provide that the selling shareholder's basis for his stock in the acquiring sister corporation shall be increased by his basis in the stock of the issuing brother corporation which he transferred. Treas. Reg. § 1.304-2(a). This treatment occurs without regard to whether the transaction is treated as a sale or exchange or as a dividend. If the transaction qualifies for sale or exchange treatment, then this transferred basis will be treated as transferred in exchange for the property received by the selling shareholder. Thus, the seller's basis for the stock in the acquiring corporation will be the same as his basis in such stock before the entire transaction. One commentator has noted that in the situation where the selling shareholder owns no stock in the acquiring corporation, if the transaction qualifies for exchange treatment, the gain "is measured by the excess of the amount distributed over the basis of the [transferred] stock." Tiger, *Sales of Stock to Related Corporations: Current Problems Under Section 304*, 40 J. Tax'n 86, 89 (1974). Additional regulations provide that in a parent-subsidiary situation, where the hypothetical redemption is treated as a § 301 distribution, the selling shareholder's basis in the transferred stock of the parent is simply added to his basis in his remaining stock in the parent corporation. Treas. Reg. § 1.304-3(a).

[76] 397 U.S. 301, 307 n.9 (1970). *See also supra* notes 50-54 and accompanying text.

[77] *See* 397 U.S. at 302.

wife owned 250 shares of common stock; and Bradley owned 500 shares of common stock.[78] In 1963, the corporation redeemed Davis' 1000 shares of preferred stock for $25,000.[79] Since his basis in the preferred stock was $25,000, Davis simply treated the transaction as a return of his capital.[80]

Ultimately, the Supreme Court concluded that the distribution in redemption of Davis' preferred stock was essentially equivalent to a dividend.[81] Since the entire distribution was treated as a dividend, the Court, to allow Davis the opportunity to eventually recoup his capital investment in the preferred stock, adopted the approach of the regulations and suggested that the $25,000 basis in the preferred stock be added to his basis in the common stock of the corporation.[82]

2. *Complete Stock Redemption Under Section 302*

a. *The* Levin *Case*

Prior to the 1954 Code, courts had broached the issue of a shareholder's lost basis and had demonstrated a reluctance to deny a shareholder the ability to recoup his capital investment.[83] Generally, courts have not been forced to rule on the proper treatment for the shareholder's basis in redeemed stock in a complete redemption failing to qualify under section 302. The Second Circuit's unexplained pronouncement in *Levin v. Commis-*

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[78] *See id.*

[79] *See id.* at 303.

[80] *See id.*

[81] *See id.* at 307.

[82] *See id.* at 307 n.9.

[83] *See, e.g.*, Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949) (payment to shareholders out of corporation's earnings for that corporation's stock found not to be a dividend). In *Snite*, the court stated:

> The lack of force of the Commissioner's reasoning is apparent, we think, when we consider the position of the taxpayers. They had acquired this stock for a certain cost. When they sold it, they accounted for their profit. If all they received is to be treated as ordinary income, what becomes of their original investment, their original cost of the stock sold to the corporation? This is a pertinent inquiry in determining not only whether there was a redemption but also in determining whether the money received by the taxpayer is to be treated as ordinary income.

Id. at 823. *See also* Penfield v. Davis, 105 F. Supp. 292, 307-308 (N.D. Ala. 1952), *aff'd*, 205 F.2d 798 (5th Cir. 1953) (exchange by corporation of debentures for preferred stock held by the corporation's shareholder deemed a recapitalization, not a dividend).

sioner,[84] although perhaps dictum, is thus the foremost judicial statement on basis recovery in a non-qualifying complete redemption.

In *Levin*, a corporation redeemed all of the stock owned by the taxpayer and her brother in order to allow the taxpayer's son to become the sole shareholder of the corporation.[85] The issue before the Second Circuit was whether the redemption would qualify for exchange treatment under section 302(b)(1). The court concluded that the attribution rules of section 318 applied and that following the redemption the taxpayer's ownership in the corporation actually increased to 100%.[86] Exchange treatment was denied under section 302, and the entire distribution was treated as a dividend. In a footnote, the court alluded to the basis problem but rejected as without merit the taxpayer's argument that imposing a tax on her gross receipts violated article 1, section 9, clause 4 of the Constitution, and concluded: "[h]er basis does not disappear; it is simply transferred to her son."[87]

The cursory treatment of the basis problem in *Levin* is not satisfactory. Although the court possibly meant to indicate that the basis, instead of being lost, would be transferred to the person or entity whose stock was attributed to the shareholder, the decanting of the redeemed shareholder's basis to the person from whom attribution arose is unsatisfactory because the basis may benefit, among others, a disinterested or even a hostile person.

b. Complete Redemptions and Section 302(b)(3)

Dividend treatment for a distribution in complete redemption of a shareholder's stock interest in a corporation could occur as a result of the taxpayer's initial failure to meet the requirements for waiver of family attribution rules under section 302(c)(2) or failure to continue to comply with the waiver requirements. The cases and revenue rulings which dictate dividend treatment in non-qualifying complete redemptions do not discuss directly the basis recovery problems, but they are, nonetheless, instructive in demonstrating the number of common factual settings in which the unresolved

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[84] 385 F.2d 521 (2d Cir. 1967).
[85] *See id.* at 523.
[86] *See id.* at 527.
[87] *See id.* at 528 n.29 (citing Treas. Reg. § 1.302-2(c)).

basis issue appears.

The taxpayer in *Chertkof v. Commissioner*,[88] owned one third of the stock in E & T Realty Company (E & T).[89] His father owned the remaining two thirds of the stock in E & T.[90] The taxpayer's father managed E & T, and when a disagreement erupted between the taxpayer and his father concerning its management, they eventually agreed that E & T would redeem the taxpayer's shares, leaving the father as the sole owner.[91] Approximately four or five months following the complete redemption of the taxpayer's stock, the father's attorney requested that the taxpayer take over the management of shopping areas owned and operated by E & T because the father's ill health prevented him from properly fulfilling this role.[92] An agreement was executed between the owner of the shopping areas and a corporation, Chertkof Company, under which Chertkof Company was to manage the properties. The taxpayer owned 80% of Chertkof Company stock and his wife and children owned the remaining 20%.[93] A primary issue in the case was whether the taxpayer could treat the distribution to him in redemption of his E & T stock as an exchange under 302(b)(3).[94] The issue's resolution depended on whether the taxpayer's father's stock would be attributed to the taxpayer or whether the taxpayer met the waiver requirement as set forth in section 302(c)(2). Although Chertkof Company was a separate and bona fide corporation, the court found that the maintenance contract gave the taxpayer, through Chertkof Company, complete control over E & T.[95] The court also concluded that such power could be used by the taxpayer for his own financial benefit.[96] Consequently, it held that the taxpayer failed to comply with section 302(c)(2)(A)(ii), which prohibits the distributee from acquiring an interest in the corporation within ten years from the date of the distribution.[97] Therefore, as a result of subsequent

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[88] 649 F.2d 264 (4th Cir. 1981).

[89] *See id.* at 265.

[90] *See id.*

[91] *See id.*

[92] *See id.*

[93] *See id.*

[94] *See id.* at 269.

[95] *See id.* at 270.

[96] *See id.*

[97] *See id.*

events, the distribution to the taxpayer was found to be subject to section 301 and taxable as an ordinary dividend.[98]

Chertkof leaves unanswered the question of the proper disposition of the taxpayer's basis in his totally redeemed stock. Admittedly, the court was not presented with this issue. However, the necessity for resolving the basis problem is heightened if, in fact, the decision in *Chertkof* was proper.

In *Estate of Webber v. United States*,[99] a father and son each originally owned 50% of the common stock of a corporation.[100] The father died and under his will left cash and real property to his son. In accordance with a corporate agreement, the corporation redeemed all of the father's stock from his estate.[101] Prior to the redemption, the son had received his cash bequest and real estate from the father's estate.[102] The question presented to the court was whether this was a complete redemption under section 302(b)(3). If the son remained as a beneficiary of the estate, then his stock would be attributed to the estate under section 318(a)(2)(A) and the estate, through constructive ownership, would own 100% of the stock of the corporation. The court concluded that the son had remained as a beneficiary of the estate because there was more than a remote possibility that the estate might seek a return of property from him or reimbursement from him for his proportionate share of the federal estate tax.[103] Once the son was determined to be a beneficiary, the court held section 302(b)(3) inapplicable and ruled that the entire distribution in re-

[98] *See id; cf.* Estate of Lennard v. Commissioner, 61 T.C. 554 (1974), *nonacq.* 1978-2 C.B. 3 (accounting services performed by a former shareholder as an independent contractor for the redeeming corporation did not constitute a prohibited interest under § 302(c)(2)(A)(i) and shareholder permitted to waive family attribution rules).

For an exhaustive analysis of what constitutes a prohibited interest under § 302(c)(2)(A), see Rose, *The Prohibited Interest of Section 302(c)(2)(A)*, 36 Tax L. Rev. 131 (1981). *See also* Comment, *Section 302(c)(2): Opportunities and Pitfalls*, 8 Fla. St. U.L. Rev. 59 (1980).

[99] 404 F.2d 411 (6th Cir. 1968).

[100] *See id.* at 412.

[101] *See id.*

[102] *See id.*

[103] *See id.* at 413; *cf.* Estate of Weiskopf v. Commissioner, 77 T.C. 135 (1981). In *Weiskopf,* trusts had been beneficiaries of an estate with which they entered into a tax apportionment agreement. Therefore, they were no longer beneficiaries when the estate redeemed certain stock and sold stock to related corporations. The estate did not constructively own the trusts' stock and §§ 302 and 304 did not apply to the estate to cause dividend treatment.

demption of the estate's stock was in the nature of a dividend.[104]

The court decided this case without taking notice of the proper treatment for the estate's basis in the stock. Presumably, the estate obtained a stepped-up basis in the stock it received from the decedent.[105] Again, it is unclear whether this basis is simply lost or is transferred to the stock owned by the decedent's son.

A number of Revenue Rulings issued by the Service have also failed to provide for the proper treatment of the basis of the stock redeemed when the redemption is treated as a dividend distribution. In Revenue Ruling 71-426,[106] the Service determined that where the completely redeemed shareholder continued in a position as a voting trustee of a trust that held the remaining stock of the corporation for the benefit of her children, she had maintained an interest in the corporation. Consequently, the children's stock was attributed to their mother. Since she could not qualify for a waiver of family attribution because of the retained interest, the distribution was treated as one to which section 301 applied. The Service did not discuss the potential basis treatment for the redeemed shareholder's stock.[107]

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[104] *See Webber*, 404 F.2d at 413-14. The court indicated that the applicability of § 302(b)(1) was not in issue. *See also supra* notes 50-54 and accompanying text.

[105] *See* I.R.C. § 1014(a)(1) (providing for step-up of basis at death to fair market value of property acquired from decedent).

[106] 1971-2 C.B. 173.

[107] *See id.* Other revenue rulings have also left this basis problem unanswered. In Rev. Rul. 75-2, 1975-1 C.B. 99, two brothers, A and B, and their father, C, owned all of the stock of X Corporation. In 1966, X Corporation redeemed all of the stock owned by A and B. When C subsequently died, A became president of X Corporation. The Service ruled that under the waiver rules of § 302(c)(2)(A), A was specifically prohibited from becoming an officer of the redeeming corporation within ten years from the date of the redemption. Consequently, A had acquired a prohibited interest in the corporation and the redemption in 1966 was recast as a distribution of property to which § 301 applied. The distribution was thus taxable in 1966 as a dividend to the extent of the earnings and profits of X Corporation at that time. No mention was made of the treatment for A's original basis in his redeemed stock.

In Rev. Rul. 70-104, 1970-1 C.B. 66, a corporation was owned by a father and his children. The corporation redeemed all of the stock owned by the father in exchange for cash. The father filed a waiver agreement pursuant to § 302(c)(2), but simultaneously entered into a five-year consulting agreement with the corporation. The Service ruled that the father, as a result of this agreement, had retained an interest in the corporation; thus he could not waive attribution to him of his children's stock. The redemption was therefore deemed not to be a termination of the shareholder's interest under § 302(b)(3). Presumably, the distribution to the father would be governed by § 301, and if the corporation had sufficient earnings and profits, the entire distribution would constitute a dividend. No provision was made for the

For a number of years, a controversy has existed concerning whether an entity could waive, under section 302(c)(2), family attribution of stock which it is deemed to constructively own through a multiple attribution chain. The stock ownership, in these cases, is attributed to an entity, such as an estate or trust, from one or more of the entity's beneficiaries.[108] The beneficiary may have constructively owned the stock through family attribution.[109] If an entity were unable to waive this family attribution, which occurred as an earlier link within the attribution chain, the number of instances where a completely redeemed entity-shareholder nonetheless receives dividend treatment under section 301 would significantly increase. The entity would lose its basis in the redeemed stock and this basis would possibly be transferred to other shareholders in the attribution chain.[110]

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potential treatment of the father's basis in his entire stock interest in the corporation.

[108] *See* I.R.C. § 318(a)(3)(A), (B).

[109] *See* I.R.C. § 318(a)(1).

[110] The Service steadfastly adhered to the position that an entity is precluded from waiving the family attribution rules. *See, e.g.*, Rev. Rul. 59-233, 1959-2 C.B. 106; Rev. Rul. 72-472, 1972-2 C.B. 702; Rev. Rul. 79-67, 1979-1 C.B. 128. The Tax Court, in Crawford v. Commissioner, 59 T.C. 830 (1973), *nonacq.* 1974-2 C.B. 5, rejected the Service's position that only individuals, and not entities, could qualify for the statutory waiver of the family attribution rules. In *Crawford*, the decedent's estate, his surviving spouse, and their two sons owned all of the shares of the corporation. The surviving spouse was the executrix and sole beneficiary of the decedent's estate. The corporation redeemed all of the stock owned by the surviving spouse and the estate and both filed § 302(c)(2) waiver agreements. *See* 59 T.C. at 833. Under the attribution rules of § 318 the estate owned all of the stock of the corporation both before and after the redemption. The Tax Court held that the estate could waive family attribution rules and specifically refused to consider whether the waiver agreement filed by the surviving spouse should be given any effect for purposes of the redemption of the estate's stock. *See* 59 T.C. at 837.

The Tax Court also repudiated the Service's position in Rodgers P. Johnson Trust v. Commissioner, 71 T.C. 941 (1979). In *Johnson*, the primary trust beneficiary owned no stock in the corporation. The Tax Court held that the trust, all of whose stock was redeemed by the corporation, could properly file a waiver agreement under § 302(c)(2) and prevent the stock of the mother of the trust beneficiary from being reattributed to the trust. *See id.* at 955. *But cf.* Title Ins. and Trust Co. v. United States, 484 F.2d 462 (9th Cir. 1973), where the parents and three trusts they established for their children owned all of the stock of a corporation. The stock owned by the trusts was completely redeemed. The court held the only section arguably applicable was § 302(b)(1), thereby implying the trusts could not qualify under § 302(b)(3), presumably because of their inability to waive the attribution from the mother and father to the children and then to the trusts. *See id.*

The Tax Court's interpretation of the waiver rights under § 302(c)(2) in *Crawford* and *Johnson* has been criticized as an unwarranted and ill-conceived expansion of the waiver of the family attribution rule. *See* Kahn, *supra* note 3, at 13; *see also* Sutton & Blume, *Waiving the Family Attribution Rules Under Section 302(c)(2): An Analysis*, 1 Tax L.J. 145

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) changed the 1954 Code to provide that an entity may waive the family attribution rules if those through whom ownership is attributed to the entity join in the waiver.[111] For example, a trust and its beneficiaries may waive family attribution to the beneficiaries if, after the redemption, neither the trust nor the beneficiaries hold an interest in the corporation, do not acquire such an interest within the ten year period, and file an agreement to notify the Service of any such acquisition.[112]

(1982) [hereinafter cited as Sutton & Blume]. *But see* Brogan, *The Interaction Between Family Attribution Rules and Corporate Redemptions*, 31 Case W. Res. 304, 327-28 (1981) (*Rickey* is a "logical extension" of *Squier* and *Haft* and reasonable "as part of a growing judicial trend to examine the congressional intent in enacting the attribution rules and to disregard these rules where the rationale for their existence is not present . . . .") [hereinafter cited as Brogan]. A major area of concern is the potential abuse which could result if only the estate or trust, and not the beneficiary, is required to file the waiver agreement. Those cases permitting an entity to waive family attribution do not preclude the attributing beneficiary from acquiring an interest in the corporation during the 10 year period from the date of distribution, do not require the beneficiary to file an agreement to notify the Service of any acquisition of an interest, and do not reopen the statute of limitations in the event of an acquisition of an interest by a beneficiary.

[111] TEFRA at § 228 (adding I.R.C. § 302(c)(2)(C)) provides:

(C) Special rule for waivers by entities.—

(i) In general.—Subparagraph (A) shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (a), and

(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

In any case to which the preceding sentence applies, the second sentence of subparagraph (A) and subparagraph (B)(ii) shall be applied by substituting 'distributee or any related person' for 'distributee' each place it appears.

(ii)Definitions.—For purposes of this subparagraph—

(I) the term 'entity' means a partnership, estate, trust, or corporation; and

(II) the term 'related person' means any person to whom ownership of stock in the corporation is (at the time of the distribution) attributable under section 318(a)(1) if such stock is further attributable to the entity under section 318(a)(3).

I.R.C. § 302(c)(2)(C) (effective with respect to distributions after Aug. 31, 1982 in taxable years ending after that date).

[112] *See* H.R. Rep. No. 760, 97th Cong., 2d Sess. 544, *reprinted in* 1982 U.S. Code Cong. & Ad. News 1318. [hereinafter cited to original source as TEFRA Conference Report]. The entity and the beneficiaries are jointly and severally liable for any tax deficiency if any one of them acquires a prohibited interest within the ten year period. *See* I.R.C. § 302(c)(2)(C)(i)(II). The amendments apply with respect to distributions after Aug. 31, 1982, in taxable years ending after such date. *See* TEFRA at § 228(b), *supra* note 111.

The requirements that TEFRA establishes for an entity to meet in order to waive family attribution increase the need for a coherent and well defined policy for the proper recovery of the redeemed shareholder's basis. The TEFRA changes could expand the instances where a redemption will be retroactively reclassified as a dividend. Not only must the entity refrain from reacquiring an interest in the corporation, but the related persons, whose family-attributed stock would have been reattributed to the entity, must also forego an interest in the corporation during the ten year period, thus enlarging the group of people who can cause the reclassification of the redemption as a dividend. At a later date, the former related person may have severed his relationship to the entity and may deem it in his best interest to acquire an interest in the corporation even though such action will cause dividend treatment to the corporation.[113]

Retroactive dividend treatment for a redemption previously classified as an exchange could create serious basis recovery problems for the redeemed shareholder. Since the event which could cause the recharacterization of the redemption as a dividend could occur anytime up to ten years after the redemption, the statute of limitations may preclude recovery of the basis in the redeemed stock.[114] Even if the statute of limitations provisions are amended to permit basis recovery, the basis should not be transferred to the attributing parties. As previously mentioned, such an approach may be too complex since the attributing parties may have transferred their own stock following the redemption. Furthermore, in light of the related person amendment of TEFRA, the redeemed shareholder's basis might be transferred to the family member from whom the related person received constructive ownership. The relationship between the redeemed entity and this family member may be too remote to justify such transfer. Consequently,

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The TEFRA Conference Report indicates that no inference should be drawn as to whether the "cases extending the waiver rules for family attribution to entities adopt a proper construction of present law." TEFRA Conference Report at 545-46.

[113] For example, the related person may have only been a contingent beneficiary of a trust who has determined that he would suffer no direct harm upon acquiring a forbidden interest. *See infra* note 129 and accompanying text. Similarly, a former shareholder of a redeemed corporation may acquire an interest in the redeeming corporation, thereby causing the earlier redemption of his former corporation to be recharacterized as a dividend.

[114] *See* I.R.C. §§ 6501, 6502.

a basis recovery system should be constructed to toll the statute of limitations and to allow the redeemed shareholder to recover directly his basis.[115]

The facts in *Rickey v. United States*[116] and certain variations on those facts suggest that there are numerous instances where a completely redeemed entity shareholder could lose the benefit of his basis in the stock. In *Rickey*, Rickey owned 1,292 shares of a corporation. His three children owned 708 shares, 40 shares and 40 shares respectively.[117] The stock owned by these family members constituted approximately 92% of the outstanding number of shares of the corporation.[118] Following Rickey's death, the corporation redeemed all of his stock from his estate.[119] The three children were the residuary beneficiaries under their father's will.[120] Immediately before the redemption, the estate owned 1,292 shares directly and 788 shares constructively from the children as beneficiaries.[121] Following the redemption the estate owned no stock directly but continued to own 788 shares by attribution from these beneficiaries.[122] The Fifth Circuit held that an estate could waive the attribution to it of stock owned by its beneficiaries when all of the stock which it owned directly was completely redeemed.[123] The estate was permitted to waive this constructive ownership even though section 302(c)(2)(A) clearly limits the attribution waiver privilege to family attribution under section 318(a)(1).[124]

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[115] *See infra* notes 185-86 and accompanying text.

[116] 592 F.2d 1251 (5th Cir. 1979).

[117] *See id.* at 1253.

[118] *See id.*

[119] *See id.*

[120] *See id.*

[121] *See id.* at 1255.

[122] *See id.*

[123] *See id.* at 1258.

[124] *See id.* Commentators have unanimously characterized this ruling as an unwarranted extension of the clear statutory language of § 302(c)(2). *See* Andrews, *Estate Waiver of The Estate-Beneficiary Attribution Rule in Nonliquidating Redemptions Under Section 302 and Related Matters: The Rickey Case in the Fifth Circuit*, 35 Tax L. Rev. 147 (1979) [hereinafter cited as Andrews]; Fassler, *Waiver of Entity Attribution - The Rickey, Jr., Case*, 57 Taxes 658 (1979); Kahn, *supra* note 3, at 12; Phillips & Kelly, *Waiver of Attribution Rules in Internal Revenue Code Section 302 Redemptions From Estates*, 5 J. Corp. L. 241 (1980); Sutton & Blume, *supra* note 110, at 167. TEFRA, by permitting only entities to waive family attribution, was explicitly intended to overrule *Rickey*. *See* TEFRA Conference Report, *supra* note 112, at 545.

If the distribution in redemption to the estate in *Rickey* should have properly been classified as a section 301 distribution, then the estate would lose its section 1014[125] basis in the stock. Arguably, this basis can be transferred to the three children as beneficiaries of the estate in proportion to their continued actual ownership in the corporation.[126] Although this approach may seem equitable in *Rickey*, it is unfair in many other situations. The following examples illustrate the problems of a simple basis transfer system.

Example 1: Father and son each owned 50% of the stock of X Corporation. They entered into a stock redemption agreement with the corporation which required the corporation to redeem the stock from the estate of the first shareholder to die. The father died and had bequeathed to his son property other than the proceeds from the redemption of the stock. The father had named his daughter as the residuary beneficiary of the estate. This residue consisted entirely of the proceeds of the father's redeemed stock. Prior to the redemption, the estate owned 50% of X Corporation directly and 50% constructively from the son through beneficiary to entity attribution.[127] Following the redemption, the estate still owned constructively 100% of the outstanding stock of X Corporation via beneficiary (the daughter) to entity attribution. Thus, through the application of the constructive ownership rules, the estate would not qualify for section 302(b)(3) treatment or section 302(b)(1) treatment.[128] The entire distribution to the estate would constitute a dividend to the extent of X Corporation's earnings and profits. The estate would lose the benefit of its section 1014 basis in the X Corporation stock, and the daughter would obtain no benefit of this basis. If the basis is transferred to the stock owned by the son, he would obtain the benefit of the basis even though he received no redemption proceeds.[129]

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[125] *See supra* note 105.

[126] One commentator noted that if the stock of the Rickey estate had been distributed equally to each child (each child was entitled to one-third of the residue of the estate), and if each child had redeemed this stock, two of the children would have qualified for exchange treatment under § 302(b)(2). *See* Comment, *Stock Redemption and The Estate-Attribution Rules*, 128 U. Pa. L. Rev. 650, 668-69 (1980).

[127] *See* I.R.C. § 318(a)(3)(A).

[128] *See* Estate of Webber v. United States, 404 F.2d 411 (6th Cir. 1983); *supra* note 99 and accompanying text.

[129] A variation of these facts involving a trust illustrates more possible inequities. A father and son each owned 50% of the stock of X Corporation. When the father died, he left his

Example 2: A, B, C, and D, all unrelated individuals, each own a 25% interest in a partnership. A and B each own 20% of the stock of X Corporation, and the partnership owns the remaining 60%. X Corporation redeems all of the partnership's stock. Before the redemption, the partnership owned 60% of X Corporation directly and constructively owned the 40% held by A and B.[130] After the redemption, the partnership continues to own constructively 100% of the stock of X Corporation via attribution from A and B. This redemption would undoubtedly fail to meet the requirements of section 302(b). If the redemption were treated as a dividend under section 301, the partnership would lose the benefit of its basis in the X Corporation stock. Transferring the partnership's basis to A and B would unfairly affect partners C and D, who would be unable to benefit directly or indirectly from this basis transfer.[131]

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entire estate, including his stock in X Corporation, in trust for the benefit of his daughter during her lifetime. The son was given a remainder interest in the trust, but contingent on his surviving the daughter. Following the distribution of the stock to the trust, the corporation redeemed all of the stock from the trust. Before the redemption, the trust owned 50% of X Corporation directly. If the contingent interest of the son in the trust is more than 5% of the value of the trust property, computed actuarially, then under § 318(a)(3)(B)(i), the trust shall be treated as owning the stock owned by the son. *See* I.R.C. § 318(a)(3)(B)(i); *see also* Rev. Rul. 76-213, 1976-1 C.B. 92. Following the redemption, if this more than 5% test is met, the trust will constructively own 100% of X Corporation. Under this analysis the trust would fail to obtain § 302 treatment and the distribution would be governed by § 301. The trust's basis in the stock would be lost to the trust and its transfer to the son would be a questionable result.

[130] *See* I.R.C. § 318(a)(3)(A).

[131] Inequities can also occur when corporations own the stock. Assume X Corporation has 100 shares of stock issued and outstanding. Y Corporation owns 40 shares, F, an individual, owns 40 shares, and A, an individual unrelated to F, owns the remaining 20 shares. Y Corporation also has 100 shares issued and outstanding of which F owns 49, A owns 49, and a trust, the sole beneficiary of which is S, the son of F, owns 2. X Corporation redeemed all of Y Corporation's 40 shares. Prior to the redemption, Y owned, directly, 40 shares of X Corporation's stock. Y Corporation also constructively owned F's 40 shares of X Corporation stock through the following chain attribution: F owned 49 shares of Y Corporation directly; the trust's 2 shares of Y Corporation stock are attributed to S (see I.R.C. § 318(a)(2)(B)); these 2 shares are then reattributed to F. *See* I.R.C. § 318(a)(1). Consequently, F owns directly and constructively 51 shares of stock in Y Corporation. Since F owns 51% of the value of the stock in Y Corporation, Y Corporation is treated as owning any stock which F owns in X Corporation. *See* I.R.C. § 318(a)(3)(C); *see also supra* note 63 (noting the substitution by the TRA of 1984 of a de minimus 5% ownership threshold for the previous 50% ownership requirement in § 304 redemptions). Y Corporation, therefore, constructively owns F's 40 shares in X Corporation. Thus, before the redemption, Y Corporation owned 80 shares out of the 100 shares of X Corporation stock. Following the redemption, Y Corporation owned no shares of X Corporation stock directly but continued to own 40 shares of X Corporation stock through attribution as outlined above. Consequently, after the redemp-

The examples are not intended to suggest that it is improper to require dividend treatment in these redemption situations. Rather, they simply illustrate basis problems which can arise when the redeemed entity continues to own stock in the corporation through attribution. These potential basis problems may have been inadvertently overlooked within the redemption scheme.[132]

c. *Complete Redemptions and Section 302(b)(1)*

When a complete redemption fails to meet the requirements of section 302(b)(3) or section 302(b)(2), dividend equivalency will be tested solely by reference to section 302(b)(1). When such a distribution in redemption is treated as a dividend, proper basis recovery for the stock redeemed again becomes a problem. This basis recovery issue can arise both in a non-hostile family situation and in a situation where family discord caused the redemption.

In *Stanley F. Grabowski Trust v. Commissioner*,[133] the Tax

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tion, Y Corporation owned 40 shares of the outstanding 60 shares of X Corporation stock. The redemption would undoubtedly fail to meet the requirements of § 302(b) and, in all likelihood, would be treated as a distribution under § 301. Merely transferring Y Corporation's basis in the X Corporation stock to the person (F) from whom attribution arose is somewhat unjust. Neither the trust nor A, an unrelated party, would receive any benefit from this basis. The result seems even harsher in that A also actually owned stock in X Corporation, but was not treated as an attributing entity.

[132] Through attribution, individuals and entities can own stock in a complex variety of relationships, giving rise to innumerable basis problem when a redemption is treated as a dividend distribution. For example, an option attribution problem could make the transfer of the redeemed shareholder's basis exceedingly difficult, if not impossible. *See* I.R.C. § 318(a)(4); Comment, *Attribution of Stock Ownership From Stock Options Under the Internal Revenue Code*, 44 U. Chi. L. Rev. 482 (1977). Suppose that F and A, two unrelated individuals, each own 50% of the stock of X Corporation. Y Corporation has an option to purchase all of A's shares. F owns 60% of the stock of Y Corporation and B, an unrelated individual, owns the other 40%. X Corporation redeemed all of F's stock. Prior to the redemption F owned 50% of the stock of X Corporation directly. Y Corporation owned 50% of the stock of X Corporation through the option attribution rule. *See* I.R.C. § 318(a)(4). Sixty percent of the X stock owned by Y Corporation is reattributed to F. *See* I.R.C. § 318(a)(3). Thus, before the redemption F owned 80% of the stock of X Corporation directly and constructively. Following the redemption of all of F's stock, Y Corporation, through option attribution, would own 100% of the stock of X Corporation. F would continue to own 60% of the X corporate stock by attribution from Y Corporation. F's stock ownership in X Corporation would have gone from 80% to 60% following the redemption. Assuming that this reduction in ownership does not constitute a meaningful reduction under § 301(b)(1), F would receive § 301 treatment on the redemption. The loss of F's basis in the X Corporation stock would be severely complicated if Y Corporation never exercised its option to acquire A's stock in X Corporation.

[133] 58 T.C. 650 (1972).

Court again encountered constructive ownership rules in determining whether a redemption is essentially equivalent to a dividend in a non-hostile family setting. A husband and wife owned 80.2% of a corporation's common stock.[134] Earlier they had established irrevocable trusts for their children and these trusts had invested in non-voting preferred stock of the corporation.[135] Each trust had invested $15,200 in preferred stock.[136] The shareholders voted to redeem all of the issued and outstanding preferred stock.[137] Each trust received $15,200 in redemption of its preferred stock.[138] The redemption price represented the par value of the preferred stock and each trust's cost for the stock.[139] The court, in testing for dividend equivalency, relied on *United States v. Davis*[140] and concluded that the attribution rules of section 318 must apply to section 302(b)(1).[141] Thus, the trusts constructively owned 80.2% of the common stock both before and after the redemption. Based on this determination, the redemption was treated as essentially equivalent to a dividend and the full $15,200 each trust received was a section 301 dividend. Conceding that in light of *Davis* the court's decision was proper, each trust lost the benefit of its basis in the preferred stock. Dividend treatment was dictated by the trust's constructive ownership of the common stock owned by the trust beneficiaries' parents. The question is whether under existing law each trust's basis should properly be transferred to the parents' common stock.

In recent years a controversy has arisen over whether family hostility constitutes an exception to the application of the attribution rules to section 302(b)(1).[142] Prior to the Supreme Court's decision

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[134] *See id.* at 654.

[135] *See id.* at 652-54.

[136] *See id.* at 654.

[137] *See id.* at 653.

[138] *See id.* at 654.

[139] *See id.* at 653-54.

[140] 397 U.S. 301 (1970).

[141] *See Grabowski,* 58 T.C. at 655. The Tax Court noted in passing that the taxpayers had not attempted to rely on § 302(b)(3) and, therefore, the issue of the waiver of family attribution rules was not before the court. *See id.*

[142] *See* Andrews, *supra* note 124, at 158-159; Brogan, *supra* note 110, at 313-322; Cathcart, *Section 302 Redemptions: Family Fights and Attribution,* 61 ABA J. 1272 (1975); Cavitch, *Problems Arising from the Attribution Rules,* Inst. on Fed. Tax'n 801, 831-33 (1977); Holden & Serling, *supra* note 54, at 572; Kahn, *supra* note 3, at 24-26; Comment, *Attribution of Stock Ownership in Redemptions by the Closely Held Corporation: David*

in *Davis*, courts took the position that when family hostility existed, the constructive ownership rules could not be applied in determining whether a redemption was essentially equivalent to a dividend under section 302(b)(1).[143] The effect of *Davis* on the family hostility exception is unclear because it involved a non-hostile family situation.[144] If the family hostility exception is ultimately rejected, the number of situations in which the basis recovery problem arises will increase. Furthermore, if a shareholder is denied exchange treatment under section 302(a) because of attribution from a hostile family member or members to whom the shareholder's basis is then transferred, a seemingly harsh injustice may result. Not only does the redeemed shareholder receive dividend treatment for the entire distribution, but he also surrenders his tax basis in the stock to a hostile party.[145]

Metzger Trust v. Commissioner, 66 Minn. L. Rev. 1235 (1982).

[143] In Estate of Squier v. Commissioner, 35 T.C. 950 (1961), *acq.* 1961 C.B. 5, *acq. withdrawn and nonacq. substituted* 1978-2 C.B. 4, the Tax Court first recognized family hostility as a mitigating factor in applying the attribution rules to § 302(b)(1) redemptions. *Accord*, Parker v. Commissioner, 30 T.C.M. (P-H) 976 (1961); *see also* Title Ins. and Trust Co. v. United States, 484 F.2d 462, 465 n.4 (9th Cir. 1973) (sympathy expressed for family discord problem) (dictum); Bradbury v. Commissioner, 298 F.2d 111, 116 n.7 (1st Cir. 1962). After *Davis*, the Tax Court retreated from its original position in *Squier*. In Robin Haft Trust v. Commissioner, 61 T.C. 398 (1971), Supp. Opinion, 62 T.C. 145 (1972), *vacated and remanded*, 510 F.2d 43 (1st Cir. 1975), the Tax Court refused to apply the family hostility test in determining whether a redemption qualified under § 302(b)(1). It concluded that the attribution rules were applicable irrespective of the personal relationships among family members. *Haft*, 61 T.C. at 403; *accord*, Niedermeyer v. Commissioner, 62 T.C. 280, 286-87 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976).

The First Circuit vacated the Tax Court's decision in *Haft*, and ruled that *Davis* was not controlling on the issue of family hostility because family hostility was not involved in the case. The court concluded that family hostility is a factor mitigating the constructive ownership rule in determining dividend equivalency under § 302(b)(1). *Haft*, 510 F.2d at 47-48. The Service has stated that it will not follow the First Circuit's decision in *Haft*. *See* Rev. Rul. 80-26, 1980-1 C.B. 67.

[144] *See supra* notes 50-58 and accompanying text.

[145] *See Haft*, 61 T.C. 398. The facts of *Haft*, and of *Metzger*, 76 T.C. 42, illustrate how such a basis problem can occur.

In 1956 Marcia Foster married Burt Haft. They had two children during this marriage and Burt adopted his wife's two children by her previous marriage. Burt was an officer and stockholder of Haft-Gaines Company. Marcia's father purchased 100,000 shares of the company's stock and, in 1962, transferred 25,000 of these shares to each of the children's trusts. *Haft*, 61 T.C. at 399. In 1966, Marcia commenced divorce proceedings against Burt. During the proceedings, Marcia's father and the children's trusts terminated their financial involvement in the corporation. Negotiations ensued concerning the redemption of the trusts' stock and ultimately it was agreed that the corporation would redeem the trusts' shares. *See id.* at 399-400.

Immediately before the redemption, the company had 500,000 shares of stock issued and outstanding. Each child's trust owned 25,000 shares directly. Burt owned 100,000 shares which each trust was deemed to own through chain attribution. *See* I.R.C. § 318(a)(1)(A)(ii), (a)(3)(B). Additionally, Burt was a one-third beneficiary in a trust which owned 100,000 shares and, under § 318(a)(2)(B), was treated as owning 33,333 shares. These shares were reattributed from Burt to each child and from the child to the child's trust. *See* 61 T.C. at 399-400. Consequently, each trust was treated as owning 158,333 shares out of a total of 500,000 or approximately 31.67% of the company's stock. Following the redemption, the company had 400,000 shares outstanding. Each trust owned no stock directly, but continued to own, constructively, 133,333 shares or approximately 33.33% of the corporation's stock. *See* 61 T.C. at 404.

The issue before the court was the relevance, after *Davis*, of family hostility in mitigation of the constructive ownership rules of § 318 in determining dividend equivalence under § 302(b)(1). If there were no family hostility exception, then the entire distribution to each trust would have been treated as a dividend. Such treatment would leave a number of questions unanswered, including whether the trusts' basis should be transferred to Burt's stock and, if such a transfer is appropriate, whether the transferred basis should be proportionately divided between the stock Burt owned directly and the stock he owned as a one-third beneficiary under a separate trust.

The Service indicated in Rev. Rul. 80-26, 1980-1 C.B. 66, that it would not follow the *Haft* decision. The Service asserted that the family hostility exception was inconsistent with both the legislative history of § 318 and with *Davis*. According to the Service, the facts and circumstances of a particular case cannot contradict the mechanical determination under § 318 of how much stock a shareholder owns. *See* 1980-1 C.B. at 67.

Metzger, 76 T.C. at 42, further highlights the questions that can arise due to the uncertain treatment of the redeemed shareholder's basis. David Metzger formed Metzger Dairies, Inc. (MDI). He had previously created the David Metzger Trust (Trust) and named his wife Nora as life income beneficiary and each of his three children, Jacob, Catherine, and Cecilia, as one-third remaindermen. The Trust subsequently became a shareholder of the corporation. *See* 76 T.C. at 43. Following Metzger's death, Jacob assumed managerial control over MDI. Eventually, hostility arose among the children. *See id.* at 44-45. To resolve the dispute, the parties agreed that MDI would redeem the stock owned by the Trust, the two sisters, and Nora, in order to allow Jacob to acquire complete control over MDI. *See id.* at 46-47. Immediately preceding the redemption, the Trust owned 420 shares of MDI directly and the remaining 2,580 shares by attribution. *See id.* at 50-51. Following the redemption, under a mechanical application of the attribution rules, the trust continued to own 100% of the outstanding stock of MDI. After the redemption, 1,221 shares of MDI were outstanding. Jacob owned 600 shares directly; a trust for the benefit of Jacob owned 120 shares; and two separate trusts for Jacob's children owned 294 shares and 207 shares, respectively. *See id.* at 48, 51.

The case raised the significant question of whether hostility among family members would nullify the application of the § 318 attribution rules to a § 302(b)(1) redemption, thereby causing it to qualify for exchange treatment as not essentially equivalent to a dividend. As noted earlier, see *supra* text accompanying note 57, the majority of the Tax Court held that where a reduction of a shareholder's proportionate direct or constructive stock ownership in the corporation does not occur following the redemption, the issue of family hostility is not reached and the distribution must be treated as essentially equivalent to a dividend. Since the trust in *Metzger* maintained a 100% constructive ownership interest following the redemption, the court refused to consider family hostility and determined that § 301 governed the distribution. *See Metzger*, 76 T.C. at 65. The Tax Court did state, however, that if there

3. Basis Recovery in Section 304 Constructive Redemptions

In *Coyle v. United States*,[146] the Fourth Circuit reviewed a section 304(a)(1) constructive redemption where the selling shareholder did not actually own stock in the acquiring sister corporation. Coyle, the selling shareholder, transferred sixty-six shares of C & R, Inc. to Realty Company for $19,800 and reported the transaction as a sale. Before the transaction, Coyle owned 369 shares of stock in C & R directly; 288 shares of C & R constructively from his three sons; and one share constructively from his wife. He owned, constructively and directly, approximately 95.6% of the corporation's stock. Realty, the acquiring corporation, was owned in equal shares by the taxpayer's three sons, each holding 125 of the 375 outstanding shares. Therefore, Coyle constructively owned 100% of Realty Company's stock. Thus, he was a person in control of two corporations within the meaning of section 304(a)(1).[147] After the transfer of the 66 shares of C & R Stock to Realty, Coyle continued to own 303 shares of C & R directly and 289 shares constructively from his wife and sons. Moreover, he still constructively owned the entire sixty-six shares transferred to Realty through attribution.[148] The court concluded that the tax-

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was a reduction in the shareholder's proportionate interest, then the court should examine all of the facts and circumstances, including family hostility, to determine if the reduction was meaningful for purposes of § 302(b)(1). *See id.* at 61.

The court's decision in *Metzger* raises the issue of the proper treatment of the trust's basis. The trust had a basis in its 420 shares of stock of $231,000. *See id.* at 49 n.2. The parties stipulated that if § 301 applied to the distribution, then approximately $434,000 should be treated as a dividend under § 301(c)(1), and the remaining amount of the distribution, approximately $151,000, should be applied to reduce the basis of the stock the trust held under § 301(c)(2). *See id.* Under this approach, the trust would be unable to recoup approximately $80,000 of its stock basis. Under present law, the proper treatment for this $80,000 is unclear. Is this portion of the trust's basis simply lost forever? Should this basis be given to the person from whom the trust received its constructive ownership, and added to that person's basis in the MDI stock? If the taxpayer constructively owns stock by way of chain attribution, should all persons in the chain obtain a pro rata share of the taxpayer's basis? In *Metzger*, the question is whether Jacob should receive the full benefit of the $80,000 basis or whether this basis should be shared, in some manner, between Jacob, the trust for Jacob, and the trust for his children.

[146] 415 F.2d 488 (4th Cir. 1968).

[147] *See supra* notes 63-65 and accompanying text.

[148] Section 304(b)(1) directs that in applying the constructive ownership rules for testing whether a redemption is an exchange or a dividend, the 50% requirement of § 318(a)(2)(E) shall not apply. Therefore, the 66 shares of C & R Realty held are attributed proportionately to the taxpayer's three sons even though none of them own more than 50% of the

payer's change in stock ownership of the issuing C & R corporation[149] remained the same and that he failed to meet any of the requirements of section 302(b); thus, the entire transfer was treated as a dividend distribution.[150] The appellate court noted in passing, the issue of the proper allocation of the taxpayer's basis in the sixty-six transferred C & R shares. Although acknowledging that the problem was not before it, the court offered two "reasonable solutions."[151] According to the Fourth Circuit, the father's basis in C & R could be added pro rata to the basis of the sons' shares in Realty. Alternatively, the taxpayer's own basis in his remaining 303 C & R shares could be increased by adding his basis in the 66 transferred shares. The court stated: "In any event, it is clear that taxpayer's basis will not disappear."[152]

Coyle failed to address the basis problem which occurs when the selling shareholder, because of constructive ownership, receives dividend treatment on the transfer but has no actual ownership in either the issuing or acquiring corporation after the transaction. The Service, in its only pronouncement on this situation, ruled that the selling shareholder's basis in the transferred stock simply disappears.[153] In Revenue Ruling 70-496, X Corporation owned 70% of the stock of Y Corporation and 100% of the stock of Z Corporation. Y Corporation owned 100% of the stock of S Corporation and sold all of this stock to Z for cash. The transaction was deemed to be an acquisition of stock by a related sister corporation under section 304(a)(1).[154] Y Corporation was a person in control of two corporations within the meaning of section 304(a)(1). After the transfer of the S Corporation stock to Z Corporation, Y Corporation continued to constructively own all of the stock of S Corpo-

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stock of Realty. These shares, in turn, are reattributed from the sons to the taxpayer under § 318(a)(1)(A)(ii).

[149] *See* I.R.C. § 304(b)(1).

[150] *See Coyle*, 415 F.2d at 493.

[151] *See id.*

[152] *Id.*

[153] *See* Rev. Rul. 70-496, 1970-2 C.B. 75.

[154] *See id.* Y Corporation was treated as the selling shareholder, S Corporation was the issuing brother corporation, and Z Corporation was the acquiring sister corporation. Before the transaction Y Corporation actually owned 100% of the stock of S Corporation. By applying § 318(a)(3)(C), Y Corporation was treated as owning any stock owned by its shareholder, X Corporation. Therefore, Y Corporation constructively owned 100% of the stock of Z Corporation. *See id.*

ration.[155] Since Y Corporation's proportionate interest in the stock of S Corporation did not change, the requirements of section 302(b) were not met and the hypothetical redemption was treated as a dividend distribution. The ruling concludes that since the selling shareholder (Y Corporation) had no direct stock ownership interest in the acquiring corporation (Z Corporation) before or after the transaction, Y Corporation's basis in its S Corporation stock disappears and cannot be used to increase the basis of any asset of Y Corporation.[156] Furthermore, the transaction has no effect on X Corporation's basis in the stock of Y Corporation or Z Corporation.[157]

This interpretation permitting a vanishing basis is patently unfair and, if followed by the Service in other instances, could force numerous taxpayers to lose forever the benefit of their capital investment. Former shareholders will be unable to directly recover their basis in the redeemed stock.

The basis problems previously discussed in connection with section 302 redemptions can also occur in a transfer to a related corporation which is recharacterized as a constructive redemption under section 304. An example illustrates these problems within a section 304 context.

Assume B and S, brother and sister, each own one-third of the stock of X Corporation. A trust owns the remaining one-third of the stock of X Corporation. B and S are equal beneficiaries of the trust. B owns 100% of the stock of Y Corporation. The relationship between B and S has become strained, and the parties have decided that S and the trust should relinquish their ownership of X Corporation. To accomplish this goal, S and the trust each sell all of their stock in X Corporation to Y Corporation for cash. The earnings and profits of Y Corporation far exceed the amounts distributed to S and the trust. Section 304(a)(1) would apply to this transaction.[158] Following the transaction S owns no stock of X

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[155] The S Corporation stock was attributed to X Corporation from Z Corporation under § 318(a)(2)(C). It was reattributed from X Corporation to Y Corporation via § 318(a)(3)(C).

[156] *See* 1970-2 C.B. 2 at 75.

[157] *See id.*

[158] Before the transfer of stock the trust owned one-third of the stock of X (issuing) Corporation directly and two-thirds from its two beneficiaries under § 318(a)(3)(B). Additionally, the trust constructively owned 100% of the stock of Y (acquiring) Corporation by attribution from B under § 318(a)(3)(B). The trust meets the control requirement of § 304(a)(1).

Corporation, directly or constructively.[159] Therefore, the transfer by S would meet the requirements of section 302(b)(3) and be classified as an exchange under section 302(a). The trust, prior to the transfer, owned 100% of the stock of X Corporation directly and constructively. Following the transaction, it owned no stock directly but continued to constructively own 100% of X Corporation stock through attribution from B.[160] The trust would fail to meet any of the requirements of section 302(b) and the entire distribution to it would be treated as a dividend pursuant to section 301. However, the trust no longer would own any stock directly in either X Corporation or Y Corporation. Is the trust's basis in its stock of X Corporation lost?[161] Is its basis transferred to B? Should its basis be prorated one-third to B and two-thirds to Y Corporation, in proportion to the actual stock ownership attributed?[162]

Section 304 would also apply to the transfer by S. *See* Treas. Reg. § 1.304-2(b), which provides that in a case where "two or more persons, in the aggregate, control two corporations, section 304(a)(1) will apply to sales by such persons of stock in either corporation to the other . . . provided the sales of such persons are related to each other." Before the transfer of her stock, S owned one-third of the stock of X Corporation directly and 50% of the one-third (one-sixth) of the stock of X Corporation owned by the trust. I.R.C. § 318(a)(2)(A).

[159] The trust only owned X Corporation stock constructively under § 318(a)(3)(C). This stock would not be attributed to S because of the operating rule of § 318(a)(5)(C).

[160] B owned one-third of the X Corporation stock directly and two-thirds by attribution from Y Corporation under § 318(a)(2)(C). All of this stock was reattributed to the trust by § 318(a)(3)(C).

[161] *See supra* notes 153-157 and accompanying text.

[162] Section 304(a)(1) would provide that Y Corporation's basis would be determined under the contribution to capital rules of § 362(a). Section 362(a)(2) provides that the basis of property acquired by a corporation as a contribution to capital shall be the same as the basis in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer. *See* Treas. Reg. § 1.304-2(a). Thus, it would seem inappropriate to add again to Y Corporation's basis (trust's original basis) two-thirds of the trust's original basis.

The facts of Niedermeyer v. Commissioner, 62 T.C. 280 (1974), *aff'd*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976), further demonstrate the need to resolve the basis problem. The taxpayers, husband and wife, owned approximately 22.58% of the voting common stock of Timber Corporation. They also owned 125 out of 2,136 outstanding shares of Timber's nonvoting preferred. Since they constructively owned an additional 67.91% of Timber's voting stock attributed to them from their sons, their total ownership, direct and constructive, of Timber was approximately 90.49%. *See* 62 T.C. at 285. Three of the taxpayers' other sons owned 67% of the outstanding stock of Lents Corporation. The taxpayers, therefore, also constructively owned this stock in Lents. Thus the taxpayers were persons in control of two corporations within the meaning of § 304(a)(1). *See id.* In September 1966, the taxpayers sold their shares of common stock in Timber to Lents. The facts indicate that

IV. Analysis of Basis Recovery Theory

Although the foregoing cases, revenue rulings and problems illustrate the varied instances in which basis recovery becomes a problem, they do not establish a procedure to permit such basis recovery. Before one attempts to create any recovery scheme, one must examine the underlying theory supporting direct basis recovery by the redeemed shareholder.

When a corporation distributes property as a simple dividend, the effect is to transfer this property from the corporation to its shareholders without changing their relative economic interests or rights.[163] Section 302 expresses congressional concern that a shareholder, whose stock is redeemed, will continue to control the corporation and to benefit economically therefrom in much the same manner as a shareholder who received a simple dividend.[164] Consequently, section 302 presumes dividend equivalency for a redemption which fails the tests of subsection (b), and prescribes dividend treatment to the extent of corporate earnings

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there may have been hostility between the three brothers who owned the Lents stock and a fourth brother who controlled Timber, and that the sale may have taken place as a result of efforts by the three brothers to acquire control of Timber. *See id.* at 284.

After the transfer of their stock to Lents, the taxpayers owned no Timber voting stock directly, but continued to own by attribution from their sons approximately 82.96% of this stock. The taxpayers made two arguments. First, that the family hostility rule should be used to mitigate the attribution to them for purposes of § 302(b)(1), and, alternatively, that they met, in substance, the requirements of § 302(b)(3) for a complete redemption. *See id.* at 285-87.

The Tax Court rejected the argument that a family hostility exception existed in a § 302 situation. Moreover, the court emphasized that the attribution rules must be mechanically applied in a § 304 situation notwithstanding any hostility between the taxpayers' sons. *See id.* at 286. The court concluded that there was no meaningful reduction in the taxpayers' proportionate interest in Timber, as required by § 302(b)(1). *See id.* at 287. Finally, the court held that the taxpayers did not qualify for a complete redemption under § 302(b)(3). After the transfer of stock to Lents, the taxpayers continued to own 125 shares of non-voting preferred stock in Timber. Although the taxpayers subsequently gave this preferred stock to a charity in December 1966, the court found that the sale of the common stock and the transfer of the preferred stock were not part of an overall plan of the taxpayers to divest themselves of all of the ownership in Timber. *See id.* at 291.

Niedermeyer leaves unanswered the question of how the taxpayers' basis in their voting stock of Timber is to be handled. The taxpayers owned no stock in the acquiring corporation to which their basis in the Timber stock could be added. *See* Treas. Reg. 1.304-2(a). Arguably, their basis in the Timber common stock should have been added to their basis in the preferred Timber stock. *See* Rev. Rul. 71-563, 1971-2 C.B. 175.

[163] *See Davis*, 397 U.S. at 313.

[164] *See id.*

and profits. The Code views such a nonqualifying redemption not as a termination of interest warranting exchange treatment, but rather as a mechanism designed to bail out earnings and profits at capital gains rates.[165] Section 302(d) attempts to provide equal tax treatment between a shareholder who receives a distribution of corporation earnings as a simple dividend and one who receives such a distrubtion in a nonqualifying redemption.

Through the attribution rules of section 318, Congress has sought to further refine this notion of equal treatment between a shareholder receiving a simple dividend and one who receives a distribution from a nonqualifying redemption. Section 318 assumes that the parties within an attribution group have such a community of interest that they have coalesced into a single unit.[166] Based on this premise, a member of an attribution group, whose stock is redeemed, is treated as continuing to own the stock of the other attribution group members, and as indirectly retaining an economic interest or other shareholder rights in the corpora-

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[165] *See id.* at 308; *see also* H.R. Rep. No. 1, 69th Cong., 1st Sess. 5 (1925).

[166] *See Metzger*, 76 T.C. at 56; *see also* Ringel, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 Harv. L. Rev. 209, 209-210 (1958); Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 Tax L. Rev. 1, 50-51 (1958).

See generally S. Rep. No. 1622, *supra* note 26, 252-53, *reprinted in* 1954 U.S. Code Cong. & Ad. News 4621, 4891, which states:

> § 318. Constructive ownership of stock
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> This section describes the area in which although in fact transactions related to stockownership [sic] are in connection with a specific individual, ownership of stock is deemed to be in the hands of persons other than the person directly involved . . . .
>
> The area of constructive ownership includes members of the family, persons having interest in partnerships, estates, trusts, and corporations, such partnerships, estates, trusts and corporations and stock held under an option.

See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. 36, *reprinted in* 1954 U.S. Code Cong. and Ad. News 4017, 4061, which states:

> A distribution in complete redemption of a shareholder's stock will also result in capital gain. To prevent evasion of the complete redemption test a shareholder is considered as owning stock held by members of his immediate family, or by partnerships, corporations and trusts which he controls. At the present time a possible opportunity for tax avoidance results where redemptions are effected in the case of family-owned corporations. To prevent tax avoidance, but at the same time to provide definitive rules for the guidance of taxpayers, your committee has provided precise standards whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls).

tion.[167] Therefore, in testing the redemption to determine if it qualifies for exchange treatment under section 302, the redeemed shareholder is treated as owning any of the stock attributed to him by section 318. The implicit presumption of section 318 is that the shareholder who continues to constructively own stock in the corporation has retained control similar to any other shareholder. When a shareholder receives a distribution in redemption of his stock, but fails to fulfill the requirements of section 302 because of his continued stock ownership through attribution, that person must receive the same tax treatment as a shareholder who received a simple dividend. To allow any other treatment would invite shareholders to bail out corporate earnings and profits at capital gains rates without the relinquishment of control which section 302 mandates.

Notwithstanding the apparent parallel between a simple dividend distribution and a nonqualifying stock redemption, these transactions are not identical. The difference in these transactions becomes quite visible when the corporation has redeemed all of the shareholder's stock in a transaction failing to meet the requirements of section 302. A shareholder who receives a simple dividend distribution retains his capital investment in the underlying stock which he will ultimately recoup as a simple return of basis or a loss deduction upon final disposition. A shareholder whose stock is totally redeemed in a nonqualifying redemption receives the same dividend treatment; however, he will be unable to recover his capital investment in the redeemed stock through a later disposition. If this shareholder loses the benefit of his stock basis, then section 302 becomes punitive instead of equalizing in nature.

The purpose behind section 302 is to provide parity of tax treatment between a dividend distribution and a redemption which is the equivalent of a dividend distribution. However, there is no parity between the redeemed shareholder and the dividend recipient if a redeemed shareholder is forced to forfeit his basis in the redeemed stock or to transfer it to another person from whom he receives attribution. If a shareholder whose actual stock is completely redeemed is denied exchange treatment under section 302

[167] *See* Bittker & Eustice, *supra* note 3, at ¶ 9.23, which indicates that entity-beneficiary and option attribution are premised on an identical economic interest, whereas the rationale for family attribution is not necessarily so based.

because of the application of the attribution rules, then he will not be treated equally with the dividend recipient as long as he is required to transfer his tax basis in his redeemed stock to the stock he constructively owns through attribution. Instead of merely protecting the policies underlying section 302 and the attribution rules, this forced transfer of the redeemed shareholder's basis may in fact be an improper extension of these rules.

The need to treat an attribution group as an integrated unit ends when the redeemed party receives dividend treatment for the distribution. The policy of denying capital gains treatment to shareholders who do not relinquish their economic interest or control in the corporation can be achieved without requiring them to forfeit the direct benefit of their capital investment by decanting it to other members of the attribution group. The constructive ownership rules may be pushed beyond justifiable limits if the members of the attribution group are forced to treat their separate bases in their stock as constructively belonging to the whole attribution group, although a transfer of basis rule for a nonqualifying complete redemption compels such a result.

A transfer of basis rule is an inappropriate solution for a number of other reasons. The unity of interest doctrine of section 318 is intended as an objective standard to provide definitive rules in determining whether a redemption is a dividend equivalent. This unity of interest may not exist in a particular case, however. Under a rigid transfer of basis rule, it could be patently unfair to require the redeemed shareholder, who has just received dividend treatment under the mechanical application of the attribution rule, to also transfer his basis to a hostile or disinterested party.[168] Furthermore, difficulties may arise in determining which parties in an attribution chain should receive the benefit of the transferred basis and the manner in which the basis should be allocated among these parties.[169]

Despite existing regulations and judicial pronouncements to the contrary, a seemingly plausible interpretation of section 302 sug-

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[168] *See supra* note 145 and accompanying text; *see also* ABA Tax Section Recommendation No. 1976-6, 29 Tax Law. 1156, 1158 (1976).

[169] *See supra* note 145 and accompanying text. Additionally, the transfer of basis to other members of the attribution group may be complicated if they have disposed of their stock prior to the time that the basis transfer is deemed necessary. *See* ABA Tax Section Recommendation No. 1976-6, *supra* note 168, at 1158.

gests that a shareholder's tax basis for redeemed stock in a nonqualifying redemption could be immediately recoverable as a loss deduction.[170] Section 317(b) establishes that stock is redeemed when a corporation acquires it from a shareholder in exchange for property.[171] However, when the property distributed in the redemption is from the corporation's earnings and profits, section 302 is designed to confine capital gains treatment to those situations where the shareholder has relinquished sufficient economic interest and shareholder rights in the corporation, as measured by the rules of section 302(b).[172] Section 302 is an exception to the general rule that a distribution by a corporation to its shareholders is treated as a dividend to the extent of corporate earnings and profits.[173] Section 302(a) will treat a distribution as "payment in exchange for the stock" if it meets any of the conditions in section 302(b).[174] One interpretation of section 302 is that it operates only to establish whether the distributed property is to be taxed as a dividend, and leaves unaltered the original characterization of the stock redemption as an exchange. That is, if the redemption fulfills any of the requirements of section 302(b), section 302(a) simply states that the property distributed shall constitute all or part of the amount realized on the transaction. If, on the other hand, section 302(d) applies, then none of the property distributed shall be treated as received in exchange for the stock.[175]

In a redemption, the shareholder has, in fact, surrendered stock in exchange for property. Section 302 does not deny the existence of the exchange but merely intervenes to limit the instances when the property the shareholder receives can be treated as part of the amount realized. Following this interpretation of the role of section

[170] One commentator, in analyzing what happens to a shareholder's basis in stock where the redemption was treated as essentially equivalent to a dividend under § 115(g) of the 1939 Code, concluded that the tax basis of the redeemed stock should be treated as a loss deduction. *See* Katcher, *supra* note 21. Although the statutory redemption provisions in the 1939 Code were somewhat different and less extensive then those of the 1954 Code, the analytical process outlined in the article is, nonetheless, instructive.

[171] *See supra* note 1.

[172] *See generally* S. Rep. No. 1622, *supra* note 166, at 43-47, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4674-78; H.R. Rep. No. 1337, *supra* note 166, at 35-38, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4060-62.

[173] *See Davis*, 397 U.S. at 304.

[174] *See id.* at 305.

[175] *See* Treas. Reg. § 1.302-1(a).

302, in instances where a distribution of property received in a redemption is treated as a dividend under section 301, the shareholder should be treated as having received zero in exchange for his stock. Although it may be paradoxical to say a shareholder who surrenders his stock for nothing has participated in an exchange, the statement is nonetheless necessary to achieve parity between a shareholder who receives a simple dividend distribution and a totally redeemed shareholder who receives dividend treatment to the full extent of the distribution.

The following example illustrates this parity. A owns 100 shares of stock in X Corporation with a basis of $5,000. B owns 100 shares of stock in Y Corporation with a basis of $5,000. X Corporation makes a dividend distribution to A of $10,000. Y redeems all of B's stock for $10,000 in a transaction which fails to qualify under section 302(b), and so the entire distribution is treated as a dividend. A has retained his $5,000 basis in the X Corporation stock which he can ultimately recover when the stock is sold or exchanged. B has surrendered all of his stock in Y Corporation, and B must be afforded a method to recoup his $5000 basis in this stock. Perhaps the most equitable mechanism would be to treat the $5,000 as an immediately deductible loss for B.[176] Although the above statutory analysis is somewhat strained, especially in its definition of "exchange," such an interpretation does attempt to provide equal basis treatment for the redeemed shareholder and may provide an impetus for legislative clarification.

Proper treatment of the shareholder's basis in a nonqualifying partial redemption further complicates the basis problem and its possible solutions. Under the above reasoning, a shareholder who experiences a nonqualifying redemption, whether partial or com-

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[176] Generally stock is property held for investment and any loss incurred on its disposition should come within the provisions of § 165. For example, if the stock were held by an individual, § 165(c)(2) would permit a deduction to the individual for losses incurred in any transaction entered into for profit. Presumably, in most circumstances, these shares of stock would be held in this capacity. Section 1001 establishes the mechanism to compute the loss deduction and provides that when the stock is sold or disposed of the loss realized is the excess of the adjusted basis over the amount realized from the sale or disposition. *See* I.R.C. § 1001. For a realized loss to be deductible, there must be a closed transaction such as a sale or exchange. If the stock is held as a capital asset, such loss will constitute a capital loss. *See* I.R.C. § 1222(2), (4). Additionally, § 165(f) provides that losses from the sales or exchanges of capital assets shall be allowed as deductions only to the extent provided in §§ 1211 and 1212. *See* I.R.C. § 165(f).

plete, should be entitled to an immediate loss deduction to recover the basis of the redeemed stock. Such an immediate loss deduction, however, would be improper for partial redemptions. To determine an adequate basis recovery procedure for nonqualifying partial redemptions, such redemptions should be classified either as pro rata or non-pro rata.

In a pro rata nonqualifying partial redemption, it is inappropriate to permit an immediate loss deduction. Such a transaction is very close to a true dividend. The shareholders do not change their proportionate interests in the corporation and are treated as simply receiving a distribution of earnings and profits. Parity between an actual dividend and a pro rata nonqualifying redemption is maintained by simply transferring the basis in the redeemed shares to the remaining shares the redeemed shareholder owns.[177]

In a non-pro rata nonqualifying partial redemption, the redeemed shareholder should also be required to transfer the basis in the redeemed stock to his remaining shares. Through this disproportionate nonqualifying redemption, the shareholder has not suffered an immediate loss, but has merely reduced his direct proportionate interest in the corporation's future growth.[178] Rather than

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[177] *See* Treas. Reg. § 1.302-2(c) (example 1); *supra* notes 71-72 and accompanying text. This example provides an excellent illustration of a pro rata redemption. *See also* Bed Rock Petroleum Co. v. Commissioner, 29 B.T.A. 118 (1933); Charles M. Haft v. Commissioner, 20 B.T.A. 431 (1930); *cf.* Rev. Rul. 70-291, 1970-1 C.B. 168 (stockholders surrendered to the company a pro rata portion of their stock; basis of the stock surrendered by each stockholder added to basis in stock retained).

[178] The judicial controversy concerning a stockholder's non-pro rata surrender of stock for no consideration is not directly applicable to a disproportionate nonqualifying stock redemption. In a long line of cases in which stockholders disproportionately surrendered some of their stock without consideration to a corporation to aid it in its financial difficulties, the Tax Court has steadfastly ruled that such a disproportionate surrender is an occasion for the recognition of a loss deduction measured by the basis of the stock surrendered, reduced by the increase in value of the stock which such shareholder retained. *See, e.g.*, Smith v. Commissioner, 66 T.C. 622 (1976), *rev'd sub nom.* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979); Estate of Foster v. Commissioner, 9 T.C. 930 (1947); Miller v. Commissioner, 45 B.T.A. 292 (1941), *acq.* 1941-2 C.B. 9, *acq. withdrawn and nonacq. substituted* 1977-1 C.B. 2; Burdick v. Commissioner, 20 B.T.A. 742 (1930), *nonacq.* 10-2 C.B. 82 (1931), *aff'd on other grounds*, 59 F.2d 395 (3d Cir. 1932).

In *Schleppy*, the Fifth Circuit reversed the Tax Court and concluded that the disproportionate transfer of stock by the two major shareholders, without consideration, did not result in an ordinary loss; the shareholders were required to add the basis of the surrendered stock to the basis in their remaining shares. *See* Schleppy v. Commissioner, 601 F.2d 196 (5th Cir. 1979), *rev'g* Smith v. Commissioner, 66 T.C. 622 (1975); *see also* Bolding, *Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?*, 32 Tax Law.

withdrawing any portion of his capital investment, the shareholder can be seen as rededicating it and should be required to treat it as a continuing capital contribution credited to his remaining stock.[179] Under this interpretation of the transaction, the shareholder suffers no permanent harm, but in an effort to mirror dividend treatment, is merely forced to postpone the recoupment of his capital investment until a true sale or exchange occurs.

A reasonable basis recovery system would thus adopt a two-pronged approach. In any nonqualifying partial redemption, the shareholder should add his basis in the redeemed stock to the basis in his remaining stock.[180] The immediate recovery of the shareholder's capital investment is not as crucial when he continues to own stock in the corporation. However, a shareholder who has received dividend treatment in a nonqualifying complete redemption must be able to recoup his basis in the redeemed stock. Such an approach is necessary to achieve parity of tax treatment for the redeemed shareholder. Therefore, the second prong in this basis recovery system would permit the shareholder to treat the nonqualifying complete redemption as an exchange. Under this approach, the amount realized on the exchange would be zero and the shareholder would recover his basis through a loss deduction.

Since section 304 hypothetical redemptions are variations on the basic section 302 redemption theme, an analogous bifurcated basis recovery procedure should be established for *hypothetical* redemptions which are treated as dividend distributions. In a section 304(a)(1) brother-sister hypothetical redemption, the selling shareholder should add his basis in the transferred stock to his basis in his stock in the acquiring corporation. Such an approach would

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275 (1979); Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 Va. Tax Rev. 81 (1983).

A shareholder who has received dividend treatment in a disproportionate nonqualifying partial redemption cannot claim to have sustained a loss in the same manner as a shareholder who has surrendered, without consideration, part of his stock in the corporation. The amount distributed to the redeemed shareholder plus his remaining percentage interest in the corporation should equal the shareholder's total interest in the corporation immediately before the redemption. The redeemed shareholder should be treated as having received a portion of his share of the corporate earnings and none of his capital investment.

[179] The transfer of the basis in the redeemed shares to the remaining shares is not really a contribution to capital, since the redeemed shareholder is not contributing any money or other property to the corporation beyond that which he originally contributed or paid for the stock.

[180] *See Davis*, 397 U.S. at 308 n.9; *see also supra* notes 76-82 and accompanying text.

recognize that the transfer of the issuing corporation's stock to the acquiring corporation constitutes a capital contribution of property. A selling shareholder who owns no stock in the acquiring corporation should add the transferred stock's basis to his basis in his remaining issuing corporation stock. Again, this procedure would compel the shareholder to keep his capital investment in corporate form, but would allow him to recover it upon ultimate disposition of the issuing corporation's stock. Finally, if the shareholder owned no stock in either the issuing or acquiring corporation, he should recoup his basis in the transferred stock through a loss deduction.

A shareholder who receives dividend treatment in a section 304(a)(2) parent-subsidiary hypothetical redemption should recover basis in a similar fashion. First, his basis in the transferred stock should be added to his basis in either the issuing or acquiring corporation. If, following the redemption, the shareholder owns no stock in either corporation, he should be permitted a loss deduction.

V. American Bar Association Legislative Proposal

In an effort to permit proper basis recovery for redeemed shareholders, remedial legislation should be enacted. Such legislation should, as closely as possible, establish similar basis recovery for shareholders receiving simple dividends and those who are treated as having received dividends in nonqualifying stock redemptions. In 1976, the American Bar Association Section of Taxation proposed legislation designed to provide a workable solution for the basis problems encountered in both sections 302 and 304.[181]

A. *Proposed Amendment to Section 302*

The Section of Taxation of the American Bar Association recommended that the basis of stock redeemed in a dividend equivalent redemption be treated in one of two ways, depending upon whether the redeemed shareholder still actually owns stock in the corporation following the redemption.[182] Under the proposal, if a

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[181] *See supra* note 24.

[182] *See* ABA Tax Section Recommendation No. 1976-6, 29 Tax Law. 1156 (1976), *amended*, 30 Tax Law. 498, 500-01 (1977) [hereinafter cited as ABA Recommendation]. It urged the adoption of a statute providing, in part:

Section 302 is amended by redesignating subsection (e) as subsection (f) and by shareholder owned stock in the corporation following the redemption, he would add the basis of his redeemed stock to the basis of his other stock in the redeeming corporation in a redemption taxed as a dividend.[183] This suggested provision follows the procedure outlined in existing regulations, and the proposal simply suggests that the task of implementing an allocation procedure be left to the regulations.[184]

If the redeemed shareholder owns (without regard to attribution rules) no other stock in the redeeming corporation after the divi-

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adding a new subsection (e) to read as follows:

(e) Basis of Stock Redeemed in Certain Cases.—

(1) In the case of a distribution described in subsection (d), the adjusted basis of the stock redeemed, determined after giving effect to section 301(c)(2),

(A) if the distributee owns (without regard to section 318) other stock in the redeeming corporation, shall be added (in accordance with regulations prescribed by the Secretary or his delegate) to the adjusted basis of such other stock, or

(B) if the distributee does not own (without regard to section 318) other stock in the redeeming corporation, shall, except as provided in paragraph (2), be treated as a loss from the sale or exchange of the redeemed stock occurring on the date of the distribution. For purposes of section 267(a)(1), the loss shall be treated as a loss from a distribution in corporate liquidation. If such loss results from an acquisition described in the second sentence of subsection (c)(2)(A) of this section, the period of limitation provided in section 6511 for the filing of a claim for credit or refund shall, with respect to any overpayment resulting from the allowance of such loss, include the period described in the second sentence of subsection (c)(2)(A) of this section, and credit or refund of such overpayment may be made notwithstanding any provision of law or rule of law which otherwise would prevent such credit or refund.

(2) Paragraph (1)(B) shall not apply if the distribution results in the allowance to the distributee of a deduction under section 243, 244 or 245, and the distribution is in pursuance of a plan having as its principal purpose the avoidance of Federal income tax. In such case, the adjusted basis of the stock redeemed, determined after giving effect to section 301(c)(2), shall be disposed of in accordance with regulations prescribed by the Secretary or his delegate and having as their purpose the prevention of avoidance of Federal income tax.

Id. For information on the ABA's adoption of the Tax Section's recommendation, see *supra* note 24.

[183] The proposed legislation would require this treatment only if the entire distribution were treated as a dividend. If the redeeming corporation did not have sufficient earnings and profits, then § 301(c)(2) would apply. *See supra* note 7 and accompanying text.

[184] *See* ABA Recommendation, *supra* note 182, at 1159. The recommendation makes no specific provisions for allocating the basis among the shares of stock which the redeemed shareholder owns but simply states: "Because the distributee [shareholder] may own various classes of stock with different holding periods and costs, the problems of allocating basis among the remaining stock may be complex, and detailed rules will be required." *Id.*

dend equivalent redemption, the proposed amendment would treat the amount of his basis in the redeemed stock as a loss from the sale or exchange of that stock.[185] In discussing the proposed legislation, the Section of Taxation concludes that the potential for abuse of this loss deduction will be quite remote because the redeemed shareholder suffers dividend treatment, which he usually would be unwilling to incur in order to realize such a capital loss.[186] Eventually, concern was expressed over the potential for a corporate shareholder to utilize the loss recovery process for tax avoidance purposes.[187] Because of the dividend deductions provided by sections 243, 244 and 245, a corporate shareholder might be able to redeem all of its stock, pay a very small tax on the amount distributed as a dividend, and obtain a very large capital loss deduction to offset any substantial capital gains which the corporation might have.[188] Although this treatment may be appropriate where the redeemed corporate shareholder, though still owning stock constructively, does not control the redeeming corporation, the Section of Taxation nonetheless feared situations where a controlled group of corporations could manipulate stock redemptions to produce beneficial capital losses.[189] Consequently, in 1977 the Section amended its original proposal to provide that a loss deduction would be denied to a completely redeemed corporate shareholder if the redemption was in pursuance of a plan having as *its principal purpose* the avoidance of federal income tax.[190] In such

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[185] *See* § 302(e)(1)(B) of proposed legislation, *supra* note 182. In most cases, this will be a capital loss. *See* ABA Recommendation, *supra* note 182, at 1159 (report also suggests situations where loss may be treated as ordinary, e.g., with respect to § 306 stock and § 1244 stock).

[186] *See id.* at 1159. If the redeemed shareholder had no capital gains in the year of complete redemption against which to offset the capital loss deduction, the shareholder (other than a corporation) would have a limited offset against ordinary income and an unlimited capital loss carryover. *See* I.R.C. §§ 1211(b), 1212(b). A corporate shareholder would receive less favorable treatment. *See* I.R.C. §§ 1211(a), 1212(a). If the redemption were retroactively reclassified as a dividend distribution because the redeemed shareholder or a related person violated the waiver rules of § 302(c)(2) by acquiring a prohibited interest within the ten year period, the proposed legislation would make the period of limitation for filing a claim for credit or refund based on the lost basis coterminous with the period of limitation for assessment and collection of the additional tax due as a result of the dividend classification. *See* § 302(e)(1)(B) of proposed legislation, *supra* note 182.

[187] *See* ABA Recommendation, *supra* note 182, at 499-500.

[188] *See id.*

[189] *See id.* at 499.

[190] *See* § 302(e)(2) of proposed legislation, *supra* note 182.

situations, the Section abandoned its automatic loss deduction provision and provided that the Secretary of the Treasury or his delegate would have the authority to promulgate regulations providing for the disposition of the basis of the corporate shareholder's stock.[191]

Finally, the proposal would permit a loss deduction notwithstanding the limitations of section 267.[192] The report, apparently recognizing that the purpose behind section 267 was to prevent the deduction of artificially created losses, intended to characterize the basis loss as an actual one and permit its recovery.

B. *Proposed Amendment to Section 304*

The ABA Section of Taxation proposal also suggested changes for section 304(a)(1) brother-sister, and section 304(a)(2) parent-subsidiary hypothetical redemptions.[193] In the brother-sister situa-

[191] The Tax Section report suggests possible alternatives for disposing of the stock basis, including deferral of basis recovery until the corporate affiliation is eliminated or reduced; transfer of the basis to the redeemed corporate shareholder's other property or to property of an affiliated corporation; or recovery of a basis through other forms established by the Secretary. *See* ABA Recommendation, *supra* note 182, at 500. The report justified a basis transfer system for corporate shareholders by noting that although such a system, if applied to individuals, would be too complex and potentially inequitable, such concerns would not be as troublesome as to corporate shareholders since corporations enjoy virtual immortality and more sophisticated accounting systems. *See id.*

[192] *See id.* at 1163.

[193] *See id.* at 501-02. The proposed legislative changes, in pertinent part, are as follows:

> Section 304(b) is amended by inserting after paragraph (2) the following new paragraph:
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> > (3) Basis.—In the case of any acquisition of stock to which subsection (a) of this section applies, if the acquisition is, by reason of section 302(d), treated as a distribution of property to which section 301 applies, the adjusted basis of the stock transferred, determined after giving effect to section 301(c)(2), shall be disposed of as provided in subparagraph (A), (B), or (C) of this paragraph.
> >
> > (A) Where Subsection (a)(1) Applies.—If the acquisition of stock is described in subsection (a)(1) of this section, such basis shall be added (in accordance with regulations prescribed by the Secretary or his delegate) to the adjusted basis of stock in the acquiring corporation owned (without regard to section 318) by the distributee. If the distributee owns (without regard to section 318) no stock in the acquiring corporation, the adjusted basis of the stock transferred shall be added (in accordance with regulations prescribed by the Secretary or his delegate) to the adjusted basis of other stock in the issuing corporation owned (without regard to section 318) by the distributee. If the distributee owns (without regard to section 318) no stock in either the acquiring or the issuing corporation, the amount of the adjusted basis of the stock transferred shall be treated as a loss from the sale or exchange of such stock

tion, if the redeemed shareholder actually owns stock in the acquiring sister corporation, the Section recommended adoption of the procedure established in existing regulations and would require the selling shareholder to add his basis in the transferred stock to his stock basis in the acquiring corporation.[194] If, however, the selling shareholder does not actually own stock in the acquiring corporation, the proposal would add his basis in the transferred stock to his basis in any remaining issuing brother corporation stock he actually owned.[195] Finally, if the selling shareholder actually owns no stock in either corporation after the transaction, he would be entitled to a loss deduction equal to the amount of his basis in the transferred stock. This loss would be treated as one from a sale or exchange.[196]

In the parent-subsidiary transfer situation, the recommendation would again follow the existing regulations and would require the selling shareholder to add his basis in the transferred stock to his basis in any issuing parent corporation stock he actually

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> occurring on the date of the distribution. For purposes of section 267(a)(1), the loss shall be treated as a loss from a distribution in corporate liquidation.
>
> (B) Where Subsection (a)(2) Applies.—If the acquisition of stock is described in subsection (a)(2) of this section, such basis shall be added (in accordance with regulations prescribed by the Secretary or his delegate) to the adjusted basis of other stock in the issuing corporation owned (without regard to section 318) by the distributee. If the distributee owns (without regard to section 318) no other stock in the issuing corporation, the adjusted basis of the stock transferred shall be added (in accordance with regulations prescribed by the Secretary or his delegate) to the adjusted basis of stock in the acquiring corporation owned (without regard to section 318) by the distributee. If the distributee owns (without regard to section 318) no stock in either the issuing or the acquiring corporation, the amount of the adjusted basis of the stock transferred shall be treated as a loss from the sale or exchange of such stock occurring on the date of the distribution. For purposes of section 267(a)(1), the loss shall be treated as a loss from a distribution in corporate liquidation.
>
> (C) The penultimate sentences of subparagraphs (A) and (B) shall not apply if the distribution results in the allowance to the distributee of a deduction under section 243, 244 or 245, and the distribution is in pursuance of a plan having as its principal purpose the avoidance of Federal income tax. In such case, the adjusted basis of the stock transferred shall be disposed of in accordance with regulations prescribed by the Secretary or his delegate and having as their purpose the prevention of avoidance of Federal income tax.

Id.

[194] *See* § 304(b)(3)(A) of proposed legislation, *supra* note 193; *see also supra* note 75 and accompanying text.

[195] *See* § 304(b)(3)(A) of proposed legislation, *supra* note 193.

[196] *See id.*

owns.[197] If the selling shareholder does not own stock in the issuing parent corporation, then he would be entitled to add the basis in the transferred stock to any stock which he actually owns in the acquiring subsidiary corporation.[198] Finally, if the shareholder does not own stock in either corporation after the transaction, the amount of the basis in the transferred stock would be treated as a loss from the sale or exchange of such stock.[199]

In 1977, the Section amended its proposal for section 304 in a manner similar to the amendment suggested for section 302. As in the section 302 situation, this amendment arose out of concern for abuse of the basis rules by redeeming corporate shareholders. A completely redeemed corporate shareholder would be denied an immediate loss deduction if it were determined that the distribution in redemption was in pursuance of a plan having as *its principal purpose* the avoidance of federal income tax.[200] As in the recommendation under section 302, the proposal would vest in the Secretary of the Treasury or his delegate the power to promulgate regulations for the disposition of the redeemed corporate shareholder's basis in the transferred stock.[201]

C. *Comment on ABA Legislative Proposal*

Generally, the legislation proposed by the Section of Taxation of the American Bar Association would implement the basis recovery principles outlined in this article. Such legislation would provide parity of tax treatment between a simple dividend distribution and a stock redemption characterized as the equivalent of a dividend distribution. A shareholder whose stock has been completely redeemed in a nonqualifying redemption should be permitted to recoup his basis through a loss deduction. A shareholder who experiences dividend treatment in a partial redemption should be required to transfer the basis in the redeemed shares to his remaining shares. This procedure would equalize as much as possible the ultimate basis treatment for shareholders who receive actual divi-

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[197] *See* § 304(b)(3)(C) of proposed legislation, *supra* note 193; *see also supra* note 75 and accompanying text.

[198] *See* § 304(b)(3)(C) of proposed legislation, *supra* note 193.

[199] *See id.*

[200] *See id.*

[201] *See id.*

dends and those who receive distributions in redemption which are classified as dividend equivalents. The ABA legislative proposal embodies this equalization approach for both nonqualifying redemptions under section 302 and nonqualifying constructive redemptions under section 304.

One area in which the legislative proposal is subject to criticism is its denial of the loss deduction to a completely redeemed corporate shareholder if the redemption was pursuant to a plan having as its principal purpose the avoidance of federal income tax. Admittedly, potential for abuse may exist where a controlled group of corporations could attempt to manipulate a redemption or constructive redemption solely for tax purposes. Nonetheless, the denial of the loss deduction to the redeemed corporate shareholder would re-introduce uncertainty into the basis recovery procedure. Perhaps a better approach would be to deny to the redeemed corporate shareholder a dividend deduction under sections 243, 244 or 245, if the redemption was in pursuance of a plan having as its principal purpose the avoidance of federal income tax. The denial of a dividend deduction may discourage redemptions for pure tax avoidance purposes, and would leave inviolate the basis recovery principles for complete redemptions.

VI. Conclusion

The present basis recovery system for stock redeemed in a nonqualifying redemption under section 302 or a nonqualifying constructive redemption under section 304 is unsatisfactory. Congress has failed to enact legislation which would allow a completely redeemed shareholder to recoup his basis in this stock. Furthermore, there are no clear guidelines for the proper treatment of the basis of stock redeemed in a nonqualifying partial redemption. The cases, revenue rulings and problems discussed in this article illustrate that basis recovery becomes a problem in numerous situations. Remedial legislation, along the lines suggested by the American Bar Association, should be enacted to provide clarity and certainty in this area.